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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1940

No. 121

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

NORTHWEST STEEL ROLLING MILLS, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR CERTIORARI FILED JUNE 1, 1940
CERTIORARI GRANTED OCTOBER 14, 1940

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APPEARANCES:

For Petitioner:

HAROLD L. SCOTT, Esq.,

D. G. EGGERMAN, Esq.,

For Respondent:

B. H. NEBLETT, Esq.,

Docket No. 93249

NORTHWEST STEEL ROLLING MILLS, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES:

1938

May 1—Petition received and filed. Taxpayer notified. (Fee paid)

May 2—Copy of petition served on General Counsel.

June 30—Answer filed by General Counsel.

June 30—Request for circuit hearing in Seattle, Washington, filed by General Counsel.

July 6—Notice issued placing proceeding on Seattle, Washington Calendar. Copy of answer and request served.

Aug. 1—Hearing set Sept. 19, 1938, Seattle, Washington.

1938

Sept. 24 & 27—Hearing had before Mr. Kern on merits. Submitted. Entry of Appearance of D. G. Eggerman filed. Petitioner's brief due 11/26/38 — respondent's due 1/25/39—reply due 2/9/39.

Oct. 13—Transcript of hearing of Sept. 24, 1938 filed.

Oct. 13—Transcript of hearing of Sept. 27, 1938 filed.

Nov. 8—Brief filed by taxpayer. 11/8/38 copy served on General Counsel.

1939

Jan. 25—Brief filed by General Counsel.

Feb. 16—Memorandum findings of fact and opinion rendered—John W. Kern, Division 16. Decision will be entered for the respondent.

Feb. 17—Decision entered—John W. Kern, Division 16.

May 10—Petition for review by U. S. Circuit Court of Appeals, Ninth Circuit, with assignments of error filed by taxpayer.

May 10—Proof of service filed by taxpayer.

May 31—Praecipe for record filed by taxpayer.

June 5—Proof of service of praecipe filed by taxpayer. [1*]

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*Page numbering appearing at the foot of page of original certified Transcript of Record.

United States Board of Tax Appeals

Docket No. 93249

NORTHWEST STEEL ROLLING MILLS, INC.,
4315 - 9th Avenue, N. W. Seattle, Washington.
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:E:6, JNW:90D), dated February 4, 1938, and as a basis of his proceeding alleges as follows:

Jurisdiction of the Board

1. The petitioner is a corporation organized under the laws of the State of Washington, with its principal office at 4315 9th Avenue, N. W., Seattle, Washington.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on February 4, 1938.

3. The taxes in controversy are income and surtaxes for the Calendar Year 1936 in the amount of Thirteen Thousand, Six Hundred Twenty-Eight Dollars and Twenty-Two Cents ($13,628.22).

Assignments of Error

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors: [2]

(a) That the Commissioner of Internal Revenue has erred in claiming that the corporation is not entitled to a credit for dividends paid on account of the contract with the Seattle First National Bank, and with the State of Washington, under the provisions of Section 26(c) 2 of the Revenue Act of 1936.

Statement of Facts

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) That prior to May 1, 1936, the corporation agreed with the officers of the Seattle First National Bank that no funds could be used for the payment of dividends until the obligations due that bank were paid.

(b) Furthermore, the corporation in its contract with the State of Washington agreed that no dividends could be paid unless the corporation had surplus earnings available, and that at no time during the Year 1936 did the corporation have surplus available for the distribution of dividends.

Wherefore, Petitioner prays that the Board may hear and determine its appeal and the petitioner further prays that the Board may give and grant such other and further relief as in the premises the

Board may deem fit and proper, and if the Board should find that the petitioner has overpaid its taxes for the year under review the Board may order and direct refund of said taxes overpaid with interest thereon.

HAROLD L. SCOTT
Counsel for Petitioner
500 Insurance Building,
Seattle, Washington [3]

State of Washington,
County of King—ss.

Harry Goetz, being duly sworn, says that he is the Treasurer of Northwest Steel Rolling Mills, Inc., a corporation organized under the laws of the State of Washington, the taxpayer named in the foregoing petition, and as such officer is duly authorized to verify the foregoing petition; that he has read the foregoing petition and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated to be upon information and belief, and those facts he believes to be true.

HARRY GOETZ

Subscribed and sworn to before me this 27 day of April, 1938.

[Seal] GENE WOODS
Notary Public in and for the State of Washington, residing at Seattle. [4]

EXHIBIT A

Office of
Commissioner of Internal
Revenue

TREASURY DEPARTMENT
WASHINGTON

February 4, 1938

Northwest Steel Rolling Mills, Inc.,
4315 9th Avenue, N.W.,
Seattle, Washington.

Sirs:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1936 discloses a deficiency of $13,628.22 as shown in the statement attached.

In accordance with section 272 (a) of the Revenue Act of 1936, notice is hereby given of the deficiency mentioned. Within ninety days, (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:Cl:P-7. The signing and filing of this form will expedite the closing of your return by permitting an early as-

sessment of the deficiency and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner.

By: Signed: CHAS. T. RUSSELL,
Deputy Commissioner.

Enclosures:
Statement
Form 870
Schedules 1, 1-A and 2. [5]

STATEMENT

IT:E:6
JMW-90D

In re: Northwest Steel Rolling Mills, Inc.,
4315 9th Avenue, N.W.,
Seattle, Washington.

Tax Liability for Taxable Year Ended
December 31, 1936.

Income Tax
Liability—$23,736.93.
Assessed—$10,108.71.
Deficiency—$13,628.22.

In making this determination of your income tax liability, careful consideration has been given to the internal revenue agent's report dated Septem-

ber 25, 1937; to your protest dated October 27, 1937 which relates to the disallowance of a dividend paid credit. and to the statements made at a conference held December 21, 1937 at the office of the internal revenue agent in charge.

On your return, line 30—"Credit for contracts restricting dividend payments"—you claimed a credit of $75,083.26. At January 1, 1936, you had an operating deficit of $75,083.26 and outstanding notes payable of $91,000.00 to the Seaboard Branch of the First National Bank of Seattle. You furnish an affidavit by C. L. Howell, Vice-President of that bank in which he states that loans were made to your company during the years 1927, 1928 and 1929; that no payments were made for several years and that in the year 1934 the bank insisted on monthly payments; that on January 17, 1934 the officials of your company agreed to make a monthly payment of $1,000.00 per month on account of principal; that these payments were continued until July 6, 1936, when the balance due of $85,000.00 was paid. He states also that the officers of your company were advised that the first funds over and above operating expenses must be used to pay off the notes; that any variation of such policy would immediately cause the bank to start suit on the notes and ask for a receiver; that at no time during the period prior to July 6, 1936, would the bank have allowed any funds to have been withdrawn from the corporation for other than actual operating expenses, and that no expenditures could have

been made for capital items or the payment of dividends in any manner whatever.

Section 26 of the Revenue Act of 1936 provides in part: [6]

> "In the case of a corporation the following credits shall be allowed - - - - - .
>
> (c) Contracts restricting payment of dividends - - -.
>
> (2) Disposition of profits of taxable year. An amount equal to the portion of the earnings of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of a taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside for the discharge of a debt, to the extent that such amount has been paid or set aside."

It will be noted that the act requires a written contract which expressly deals with the disposition of earnings and profits of a taxable year. In this connection you state in your protest dated October 27, 1937:

> "While it is agreed that there was no written contract in existence, there was a verbal contract between the officers of this company and the officers of the Seattle First National Bank, that funds could not be used for any other purpose than the payment of the notes as of January 1, 1936, amounting to $91,000.00."

It is believed that the verbal agreement does not satisfy the requirements of section 26(c) (2) of the Revenue Act of 1936 under which you claim the credit and the action of the internal revenue agent is sustained.

A copy of this letter, together with a copy of the statement and schedules, has been mailed to your representative, Mr. H. L. Scott, in accordance with the authority contained in the power of attorney executed by you and on file with the Bureau. [7]

Northwest Steel Rolling Mills, Inc.
Taxable Year ended December 31, 1936.

Schedule 1

Adjustments to Net Income

Net income as disclosed by return		$75,124.71
As corrected		76,049.71
Net adjustment as computed below		$ 925.00
Unallowable deductions:		
(a) Peck & Hill Furniture Co. stock	$1,000.00	
Additional deductions:		
(b) Accrued capital stock tax	75.00	
Net adjustment as above		$ 925.00

Schedule 1-A

Explanation of Items

(a) In December 1929 you purchased some convertible preferred stock of the Peck & Hills Furniture Company at a cost of $1,000.00 which you charged off in 1936 and took as a deduction on your return for that year.

The facts developed in this case show that bankruptcy proceedings began in August 1933. No evidence has been presented as to the settlement with the stockholders, and the deduction claimed is disallowed for the reason that no loss in the year 1936 has been established.

(b) You made your return on the accrual basis and capital stock taxes accrued for the current taxable year are allowable deductions. [8]

Capital stock tax for capital stock tax year ended June 30, 1937, accrued July 1, 1936, (G.C.M. 17340, Cumulative Bulletin XV-2, page 81, year 1936)	$ 975.00
Capital stock deducted for capital stock tax year ended June 30, 1936, which accrued July 1, 1935 and was allowable as a deduction in the taxable year ended December 31, 1935 (G.C.M. 17340)	900.00
Additional deduction	$ 75.00

Schedule 2

Computation of Tax

Excess-Profits Tax

Net income for excess-profits tax computation	$76,049.71
Less:	
10% of $900,000.00 value of capital stock as declared in your capital stock tax return for year ended June 30, 1936	90,000.00
Net income subject to excess-profits tax	None
Excess-Profits tax	None
Excess-Profits tax assessed,	
Original, account #402067	None
Deficiency or overassessment of excess-profits tax	None

Normal Tax

Net income for income tax computation	$76,049.71
Normal tax net income	$76,049.71

[9]

8% of $ 2,000.00 (Over 0 to $ 2,000)	$ 160.00
11% of $13,000.00 (Over $ 2,000 to $15,000)	1,430.00
13% of $25,000.00 (Over $15,000 to $40,000)	3,250.00
15% of $36,049.71 (Over $40,000)	5,407.46
Total normal tax	$10,247.46

Surtax on Undistributed Profits

Net income for surtax computation		$76,049.71
Less:		
Normal tax		10,247.46
(a) Adjusted net income		$65,802.25
Less:		
Dividends paid credit	None	
Credit for contracts restricting dividend payments	None	None
(b) Undistributed net income		$65,802.25
(c) Remainder subject to surtax		$65,802.25
7% of $ 6,580.23 [Portion of (c) not over 10% of (a)]		$ 460.62
12% of $ 6,580.23 [Over 10% and not over 20% of (a)]		789.63
17% of $13,160.45 [Over 20% and not over 40% of (a)]		2,237.28
22% of $13,160.45 [Over 40% and not over 60% of (a)]		2,895.30
27% of $26,320.89 [Over 60% of (a)]		7,106.64
Amount of Tax		$13,489.47
Plus:		
7% of Specific Credit		None
Total surtax		$13,489.47
Normal tax		10,247.46
Total normal tax and surtax		$23,736.93
Normal tax and surtax assessed, Original, account #402067		10,108.71
Deficiency of income tax		$13,628.22

[Endorsed]: U.S.B.T.A. Filed May 2, 1938.

[10]

[Title of Board and Cause.]

ANSWER

Comes now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed herein, admits and denies as follows:

1. Admits the allegations of paragraph 1.
2. Admits the allegations of paragraph 2.
3. Admits that the taxes in controversy are income and surtaxes for the calendar year 1936. Denies the remaining allegations of paragraph 3.
4. Denies that the Commissioner committed the error alleged in subparagraph (a) of paragraph 4.
5. Denies the allegations of subparagraphs (a) and (b) of paragraph 5.

Denies generally and specifically each and every allegation contained in the petition and not hereinabove admitted, qualified or denied. [11]

Wherefore, it is prayed that the Board redetermine the correct amount of the deficiency involved in this proceeding to be equal to the amount determined by the Commissioner, viz., $13.628.22.

[Signed] J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:
F. R. SHEARER,
JAMES C. MADDOX,
Special Attorneys,
Bureau of Internal Revenue.

[Endorsed]: U.S.B.T.A. Filed June 30, 1938.

[12]

[Title of Board and Cause.]

H. L. Scott, Esq., and Donald G. Eggerman, Esq., for the petitioner.

B. H. Neblett, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

This proceeding involves a deficiency in the income tax liability of petitioner, determined by respondent for the taxable year 1936 in the sum of $13,628.22. This deficiency results from respondent's disallowance of a credit of $75,085.26 for contracts restricting dividend payments claimed by the petitioner in computing its surtax on undistributed profits under section 26 of the Revenue Act of 1936. [13]

FINDINGS OF FACT.

Petitioner is a corporation which was organized in 1926 under the general corporation laws of the State of Washington, and receiving its charter to carry on business as a corporation from that State. Its principal place of business is Seattle, Washington.

Petitioner's surplus by appraisal at the beginning of 1936 was the sum of $134,173.90, and its surplus by appraisal at the end of that year was the same amount. Its operating deficit as of December 31, 1935 was the sum of $76,983.26, and its net income for the year ended December 31, 1936 was the sum of $76,049.71. From 1926 to 1936 petitioner was

indebted in considerable sums to the Seattle First National Bank, Seaboard Branch. This indebtedness was evidenced by notes due in ninety days which were from time to time renewed. The amount of this indebtedness at one time had been the sum of $150,000, but by January, 1934, had been reduced to the approximate sum of $115,000. The amount of this debt was subject to criticism by the bank examiners and the executive committee of the bank, and accordingly, when petitioner proposed to renew the notes evidencing this indebtedness in January, 1934, the officer of the bank who was handling this matter stated to the officers of petitioner that a condition of the renewal of these notes would be a payment by petitioner of $1,000 a month in a reduction of the principal amount of the indebtedness, together with the payment on this indebtedness of any available surplus in the treasury of petitioner after the payment of its current operating expenses. Petitioner was given to understand by the [14] officer of the bank in the course of these conversations that in case of a breach of this condition by petitioner the bank would apply for the appointment of a receiver for petitioner's assets. This condition to the renewal of these notes was not reduced to writing and no written contract was ever executed by petitioner which dealt with the payment of dividends. From January, 1934, to July, 1936, the amount of petitioner's indebtedness to the bank was reduced to the sum of $85,000, and this amount was paid on July 6, 1936.

OPINION.

Kern: The Sections of the Revenue Act of 1936 which are involved in this proceeding are section 14 (a)(2) and section 26 (c)(1)(2), which are set out in the margin.[1] [15]

---

[1]Sec. 14. Surtax on Undistributed Profits.

(a) Definitions.—As used in this title—

* * * * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided by section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

Sec. 26. Credits of Corporations.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * * *

(c) Contracts Restricting Payment of Dividends.—

(1) Prohibition on payment of dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) Disposition of Profits of Taxable year.—An amount equal to the portion of the earnings and

Petitioner contends that its charter from the State of Washington, granted prior to May 1, 1936, and the general corporation laws of the State constitute a written contract entitling petitioner to the exemption under section 26 which we have set out above, since, under its charter and the laws of that State, it could not have legally paid dividends during the taxable years. It is petitioner's further contention that if the Act is construed in such a way as not to recognize the charter of a corporation and the laws of the state of its creation as a "written" contract within the meaning of the Act, then the Act is unconstitutional.

The oral agreement between petitioner and the bank, whereby all of the revenues of petitioner over and above its current operating expenses were to be applied to a reduction of its indebtedness to the bank, was, obviously, not "a written contract

---

profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt); to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

executed by the corporation" which "expressly deals with the payment of dividends" within the meaning of the Act, nor does petitioner so contend. Petitioner, however, contends that the Act, because it grants an exemption to a corporation obligated with regard to the non-payment of dividends under a written contract while it withholds such exemption from a corporation similarly obligated under an oral contract, is in violation of the Fifth Amendment, [16] and is, therefore, unconstitutional.

Similar contentions were made by the petitioner in Crane Johnson Co., 38 B.T.A. 1355, and were held by us to be without merit. Upon the authority of that case, therefore,

Decision will be entered for the respondent.

Entered Feb. 16, 1939. [17]

UNITED STATES BOARD OF TAX APPEALS
WASHINGTON

Docket No. 93249

NORTHWEST STEEL ROLLING MILLS, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the determination of the Board, as set forth in its Memorandum Findings of Fact and Opinion, entered February 16, 1939, it is

Ordered and Decided: That there is a deficiency in income tax of $13,628.22 for the year 1936.

(Signed) JOHN W. KERN,
Member.

Entered Feb. 17, 1939. [18]

[Title of Board and Cause.]

PETITION FOR REVIEW AND ASSIGNMENTS OF ERROR.

Now comes Northwest Steel Rolling Mills, Inc., a corporation organized under the laws of the State of Washington, by its undersigned counsel and respectfully shows:

I.

Jurisdiction

Petitioner on review is a corporation duly organized and existing under and by virtue of the laws of the State of Washington, with its principal office in Seattle, Washington.

Respondent on review is the duly appointed, qualified, and acting Commissioner of Internal Revenue of the United States of America, holding his office by virtue of the laws of the United States. [19]

Petitioner on review filed its income tax return for the calendar year 1936, with the Collector of Internal Revenue for the District of Washington and within the judicial circuit of the United States Circuit Court of Appeals for the Ninth Circuit.

Thereafter, a controversy arose between Petitioner and Respondent in which Respondent claimed Petitioner was liable for a deficiency of income and surtaxes for the calendar year 1936, in the sum of Thirteen Thousand Six Hundred Twenty-eight Dollars and Twenty-two Cents ($13,628.22).

Petitioner appealed to the United States Board of Tax Appeals from the claim of deficiency of Respondent and under date of February 16, 1939, the United States Board of Tax Appeals entered findings of fact and opinion and decision favoring Respondent, Commissioner of Internal Revenue.

Petitioner *in* review files this petition pursuant to the provisions of Sections 1001, 1002, and 1003 of the Revenue Act of 1926, as amended by Section 603 of the Revenue Act of 1928, as amended by Section 1101 of the Revenue Act of 1932, as amended by Section 519 of the Revenue Act of 1934.

II.

Nature of Controversy

Respondent claimed a deficiency against Petitioner resulting from Respondent's disallowance of a credit of $75,085.26 for contracts restricting dividend payments claimed by [20] Petitioner in computing its surtax on undistributed profits under Section 26 of the Revenue Act of 1936. Petitioner received its charter from the State of Washington

in the year 1926, and in 1936, was operating under said charter. On January 1, 1936, the company had a deficit in the amount of $76,983.26. On May 1, 1936, Petitioner owed Seattle-First National Bank the sum of $85,000.00 and during the year 1936, this indebtedness was paid. Petitioner had agreed with Seattle-First National Bank that no dividends could be paid until monies due the Seattle-First National Bank had been paid.

The taxable net income of Petitioner for the year 1936 was $76,049.71.

Petitioner contended that by reason of its oral agreement with the bank, it was prohibited from paying any dividends and further that Section 26 (c) (1), (2) grants an exemption to a corporation obligated with regard to non payment of dividends under a written contract while withholding such exemption from a corporation similarly obligated under an oral contract and is therefore in violation of the Fifth Amendment of the Constitution of the United States.

A further issue in the controversy involved the effect of the Uniform Business Corporation Act of the State of Washington and its provisions restricting corporations from distributing dividends under certain circumstances, Paragraph 3803-24 (2) to (5) inclusive of said Act being as follows: [21]

> "(2) Amounts of surplus arising from an unrealized appreciation or revaluation of fixed assets shall be shown on the books of the cor-

poration as a separate item apart from surplus profits or paid-in surplus.

"(3) In computing the aggregate of the assets of the corporation, the Board of Directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off at least annually in proportion to their use as may be determined by the Board of Directors.

"(4) No corporation shall pay dividends, (a) in cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets; (b) in shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock.

"(5) Cash dividends shall not be paid out of surplus due to or arising from, (a) any profit on treasury shares before resale; or (b) any unrealized profits due to increase in valuation of the inventories before sale; or (c) the unaccrued portion of unrealized profits on notes, bonds, or obligations for the payment of money purchased or acquired at a discount

unless such notes, bonds, or obligations are readily marketable, in which case they may be taken at their actual market value; or (d) the unaccrued or unearned portion of any realized profit in any form whatever, whether in form of notes, bonds, obligations for the payment of money, instalment sales, credits or otherwise."

Petitioner contended that under its charter with the state it could not have legally paid dividends during the taxable [22] year 1936, and is therefore exempt under Section 26 because of a written contract.

In the alternative, Petitioner contended that if the Act is construed in such a way as not to recognize the charter of a corporation and the laws of the state of the corporation's creation as a "written" contract within the meaning of the Act, then the Act is unconstitutional.

The Board of Tax Appeals rejected all of these contentions of Petitioner and entered a decision for Respondent.

III.

Assignments of Error

Petitioner on review avers that in the record and proceedings before the Board of Tax Appeals, and in the opinion and final decision rendered and entered by the Board of Tax Appeals, manifest error occurred and intervened to the prejudice of Petitioner who now assigns the following errors and each of them, which Petitioner avers occurred in said record, proceedings, findings, opinion, and

final decision so rendered and entered by the Board of Tax Appeals.

(1) The Board erred in entering a decision for Respondent resulting in a deficiency against Petitioner in the sum of $13,628.22.

(2) The Board erred in holding that the charter and general corporation laws of the State of Washington are not a written contract within the meaning of Section 26 of the Revenue Act of 1936. [23]

(3) The Board erred in denying Petitioner's contention that Section 26 of the Revenue Act of 1936 is invalid and unconstitutional insofar as it relates to Petitioner and to Petitioner's charter and contract with the State of Washington under which it is incorporated.

(4) The Board erred in refusing to sustain Petitioner's contention that Section 26 of the Revenue Act of 1936 is unconstitutional and in violation of the Fifth Amendment of the Constitution of the United States of America because it grants an exemption to a corporation obligated with regard to the non-payment of dividends under a written contract while it withholds such exemption from a corporation similarly obligated under an oral contract.

(5) The Board erred in failing to redetermine Petitioner's income tax and surtax for the calendar year 1936, and to decide that there was no deficiency for said year.

(6) The Board erred in that its decision is not supported by the evidence and stipulation of facts and is contrary to law.

Wherefore, Petitioner on review respectfully petitions this Honorable Court that the decision of the Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Ninth Circuit, that a transcript of the record be prepared in accordance with the law and with the rules of said Court and transmitted to the clerk of said Court for filing, and that appropriate action be taken to the end that the errors [24] complained of may be reviewed and corrected by said Court.

D. G. EGGERMAN
Counsel for Petitioner on Review

United States of America,
District of Washington—ss.

D. G. Eggerman, being duly sworn, says: That he is one of the attorneys for Petitioner on review and as such is duly authorized to verify the foregoing Petition for Review; that he has read said petition and is familiar with the contents thereof; that said petition is true of his own knowledge, except as to the matters therein alleged on information and belief, and as to those matters he believes it to be true.

D. G. EGGERMAN

Subscribed and sworn to before me this 8 day of May, 1939.

[Notarial Seal] KATHRYN BENDER
Notary Public in and for the State of Washington, residing at Seattle.

My Commission expires Sept. 6, 1941.

[Endorsed]: U.S.B.T.A. Filed May 10, 1939. [25]

[Title of Board and Cause.]

NOTICE OF FILING PETITION FOR REVIEW

To: Commissioner of Internal Revenue, Washington, D. C.

To: B. H. Neblett, Esq.,
Joseph B. Harlacher, Esq.,
Hon. J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue,
Appearing on behalf of Respondent, Commissioner of Internal Revenue:

You are hereby notified, that Northwest Steel Rolling Mills, Inc. did, on the 10 day of May, 1939, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit, of the decision of the Board of Tax Appeals heretofore rendered in the above entitled case. A copy of the petition for review and of the assignments of error as filed with the Clerk of the Board of Tax Appeals is hereto attached and served upon you. [26]

Dated this 10 day of May, 1939.

D. G. EGGERMAN
Attorney for Petitioner on Review
Northwest Steel Rolling Mills, Inc.

Personal service of the above and foregoing Notice, together with a copy of the Petition for Review

and of the Assignments of Error mentioned therein, is hereby acknowledged this 10th day of May, 1939.

COMMISSIONER OF INTERNAL REVENUE
J. P. WENCHEL
Attorneys for Respondent,
Commissioner of Internal Revenue.

[Endorsed]: U. S. B. T. A. Filed May 10, 1939.
[27]

[Title of Board and Cause.]

REPORTER'S MINUTES
(Testimony)

Hearing at Seattle, Washington, on the 24th day of September, 1938, at 11 o'clock, a. m.

The above-entitled proceeding came on for hearing on this the 24th day of September, 1938, before the Honorable John W. Kern, Member of the United States Board of Tax Appeals, at Seattle, Washington, pursuant to notice of hearing heretofore given; whereupon, the following proceedings were had and testimony heard, to-wit:

Appearances:

D. G. Eggerman, Esq., Exchange Building, Seattle, Washington, and H. L. Scott, Esq., Insurance Building, Seattle, Washington, appearing in behalf of Petitioner.

B. H. Neblett, Esq., Smith Tower, Seattle, Washington, and Joseph B. Harlacher, Esq., Smith Tower, Seattle, Washington, (Honorable J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue), appearing on behalf of the Commissioner of Internal Revenue, Respondent. [28]

PROCEEDINGS

The Clerk: Case No. 93249, Northwest Steel Rolling Mills Company, Inc.

The Member: Please state your appearances for the record.

Mr. Eggerman: D. G. Eggerman. I do not appear on the petition, but Mr. Scott has asked that I join, and I spoke to Mr. Neblett about it.

The Clerk: Are you admitted to practice before the Board?

Mr. Eggerman: Yes, sir.

Mr. Neblett: B. H. Neblett, and Joseph B. Harlacher, for the respondent.

STATEMENT OF CASE ON BEHALF OF PETITIONER:

Mr. Eggerman: In this case, if the court please, it was my understanding last night that they had, but I am now informed that the government has not agreed to the exact amount of the deficit. But assuming that that will be agreed upon, the first three——

Mr. Neblett: Right on that point, Mr. Eggerman, I don't believe it can be agreed upon at this time. There is a question here, Your Honor, as to

the type of deficit, whether it is an adjustment deficit, or an operating deficit. If it is all in one book, we will ask that the book be put in.

Mr. Scott: If I could say a word there, this account, I [30] believe, could be reconciled. If we could say that on Wednesday morning we would enter the stipulation as to what the amount is, I don't think there will be any argument between us as to the exact amount. All we have to do is take the returns from the year 1926 and bring them down to date, taking into consideration the adjustments made by the agents in their various examinations, and adjust the figure.

The Member: Well, you are talking about a matter that I know nothing of. You mention the deficit, and I don't know in what way it is relevant or what kind of a deficit it is.

Mr. Eggerman: I will continue with my statement.

The first paragraph of the stipulation of facts to which the government agrees is that the taxpayer petitioner is a corporation under the general laws of the state of Washington, and received its charter in the year 1926, with its principal office at Seattle, Washington; that on January 1st, 1936, the company had a deficit in the amount of $76,983.36, the amount of that deficit has been referred to; third, that the taxable net income for the year 1936 was $76,049.71. In that connection, we assume, and I think Mr. Neblett will agree, that Your Honor takes judicial notice, and the Board takes

judicial notice of the statutes of the state of Washington. The statutes for convenience have been copied into the proposed stipulation of fact, under paragraph 7, with its [31] sub-sections. The facts which are not stipulated and which will not be stipulated, as I understand it, are referred to in the proposed stipulation of facts, 4 to 6 inclusive, namely, that on May 1st, 1936, the corporation owed to the Seattle-First National Bank, Seaboard Branch, the sum of $85,000. This, during the year 1936, this indebtedness was paid to the Seattle-First National Bank, Seaboard Branch. Sixth, that petitioner corporation had an oral contract with Seattle-First National Bank, Seaboard Branch, to the effect that no dividends could be paid until monies due the Seattle-First National Bank, Seaboard Branch, were paid.

Now, with respect to the stipulation of facts, 1 to 3, we believe that there will be and can be no issue of fact, between the petitioner and the government, save and except as to the paragraphs 4 to 6 inclusive, referring to the indebtedness to and the oral contract with the bank. The agent's report, Exhibits A and A-1, dated September 25, 1937, which report is referred to in the letter of the Commissioner, a copy of which is attached to our petition, and which is dated February 4, 1938, recites the amount of that deficit, the dates, the amount of the taxable income for the year 1936, and recognizes that the petitioner is a corporation or-

ganized under the general laws of the State of Washington, receiving its charter in 1936.

Our position is, if the court please, that practically [32] this entire case involves a pure question of law, namely, as to the exemption under Section 26 of the Revenue Act of 1936. Our position, in a nut-shell, is this, that prior to May 1, 1936, and thereafter, the petitioner was under an oral contract with its creditor, the Seattle-First National Bank, expressly preventing the distribution and payment of dividends. Second, that the corporation's charter from the state of Washington, which was granted prior to May 1, 1936, and the general corporation laws of the state of Washington, constitute a written contract entitling the corporation to the exemption under Section 26 of the Revenue Act. And, finally, if that section of the 1936 Act denies credit to the petitioner for an oral contract with its creditor, antedating the enactment of the law, it constitutes an arbitrary discrimination against the taxpayer already effectively bound by an oral contract in favor of a taxpayer bound by a written contract, and, furthermore, if it also denies credit for the contract with the state of Washington, which was in full force and effect on the 1st of May, 1936, which contract was evidenced not only by its charter but by the general law governing corporations of the state of Washington, it constitutes an illegal interference with state power, and in any event is unconstitutional.

If Mr. Neblett is agreeable to the [33] beginning of the introduction of evidence, I will proceed to introduce evidence on the relations with the bank.

STATEMENT OF CASE ON BEHALF OF RESPONDENT:

Mr. Neblett: Your Honor, I want to make just a short statement. Since opposing counsel has made more or less of an argument under the law, rather than a statement of facts, I will read the statute so that Your Honor may clearly understand the evidence as it is in relation to the act. It is an interesting question, Your Honor, as to the payment of dividends, and more or less a question of first impression. We do not have a Board case on it, nor are we able to find any Circuit Court case on it.

The Revenue Act of 1936 provides in part as follows:

"Section 14. Surtax on Undistributed Profits. (a) Definitions, as used in this title.

"2. The term 'undistributed net income' means adjusted net income minus the sum of the dividends paid, credits provided in Section 27, and the credits provided in Section 26(c) relating to contracts restricting dividends."

That 26 (c) is the one applicable here.

"Section 26, Credit of Corporations. In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax.

"(c) Contract restricting payments of dividends.

"(1) Prohibition payment of dividends. An amount equal [34] to the excess of the adjusted net income over the aggregate of the amounts which can be distributed in the taxable year as dividends without violating the provisions of a written contract."

That is the thing we want to call distinctly to Your Honor's attention, "without violating the provisions of a written contract, executed by the corporation prior to May 1st, 1936, which provision expressly deals with the payment of dividends."

Right on the threshold of this case, it is admitted there is no written contract as far as any specific contract referring to this particular transaction is concerned. They are trying to read the state law or the charter of the corporation, it being a written contract, but it is conceded that there is no written contract referring specifically to this particular transaction. In other words, they are going to try to prove an oral contract. It seems to show that they are not relying on a written contract.

Now, Article 26-2(b) of Regulation 94, relating to the Revenue Act of 1936, provides in part as follows:

"(b), Prohibition on payment of dividend. The credit provided in Section 26 (c) 1, is allowable only with respect to a written contract executed by the corporation prior to May 1st, 1936, which expressly deals with the payment of dividends, and operates as a legal restriction upon the cor- [35] poration as to the amounts which it can distribute within the taxable year as dividends."

That simply means, Your Honor, that if this corporation can show a contract restricting dividends and the amount of an assumed figure, say $10,000, then they are entitled to a credit of $10,000. That is all.

Now, the situation is this. No evidence of this oral contract with the bank is admissible here. The statute specifically says and calls for a written contract prior to May 1st, 1936. Now, that being the case, Your Honor, unless they can show a written contract, they can not proceed in this case.

However, Article 26-2 of Regulations 94, promulgated on the Revenue Act of 1936, expressly provides that the charter of a corporation does not constitute a written contract executed by the corporation within the meaning of Section 26(c). Furthermore, in IT306CB page 73, it has been held that a corporation is subject to the surtax imposed by Section 14 of the Revenue Act of 1936 on its distributed net income for 1936, even though the corporation is restricted by state law in declaring and paying dividends while its capital remains unimpaired.

Now, Your Honor, coming back to the facts in the case for just an instant. The government will stipulate two things in that proposed stipulation that Mr. Eggerman read [36] from. First, that the taxpayer is a corporation under the laws of the State of Washington receiving its charter in the year 1926, having its principal office at Seattle, Washington. Second, that the taxable net income for the year 1936 was $76,049.76. Now, with respect

to petitioner's proposed stipulation, that is all that respondent will agree to.

The Member: Call your witness.

CHARLES H. HOWELL

called as a witness by and on behalf of the petitioner, having been first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Eggerman:

Q. How long have you been an officer of the Seattle-First National Bank?

A. Well, prior to the First National it was the Seaboard National.

Q. Yes.

A. If you go back to the Seaboard National, which is a unit, of course, of the present organization since 1916.

Q. You are acquainted with the officers of the petitioner, the Northwest Steel Rolling Mills, are you not? A. I am.

Q. Who in your bank had charge of the loans and transactions with that corporation? [37]

A. I did.

Q. When did your bank's loans to the petitioner begin?

A. Loans in large figures, so to speak, started in '26. Previous to that they had small loans, ten and twenty thousand dollars.

Mr. Neblett: If Your Honor please, at this time I would like to ask Mr. Eggerman the purpose of this testimony.

(Testimony of Charles H. Howell.)

Mr. Eggerman: I have indicated in my opening statement that I expect to prove an oral contract. We are not arguing the law, I take it, today.

Mr. Neblett: That is all I wanted to know.

This line of testimony is objected to on the ground that the contract and certificate and dividends must be evidenced by a written contract. The petitioner is trying to prove an oral contract, which obviously is the furtherest possible direction from a written contract. In view of the statute, the wording of the statute, the written contract must have been in existence prior to May 1st, 1936, and all of this line of testimony is objected to as being incompetent, irrelevant and immaterial, because the statute required a written contract.

The Member: Well, the question that you raise on evidence, in objection to the evidence, is the sole question in the case, as I take it.

Mr. Neblett: That is about it.

The Member: If I should sustain your objection, the [38] petitioner would not be able to proceed in this proceeding along the theory that is his theory.

Mr. Eggerman: That is one of my theories, if Your Honor please.

The Member: I will overrule the objection, it being understood that it in no way indicates my ultimate decision in the case, but it certainly is a matter that I would want to have briefed and consider a little bit more fully than I can in making a snap judgment on an objection.

(Testimony of Charles H. Howell.)

Mr. Neblett: Exception allowed, Your Honor?

The Member: An exception will be allowed and will be borne in mind.

Mr. Eggerman: In view of counsel's objection, if Your Honor please, may I suggest to counsel, since he submits that the allegations in our proposed stipulation of fact, 4, 5, and 6, are wholly immaterial as a matter of law, why can't we shorten this proceeding by counsel admitting without waiving his objections as a matter of law the allegations in 4, 5, and 6, if he feels that it is incompetent, irrelevant and immaterial?

Mr. Neblett: Well, we prefer to proceed in our own fashion, Mr. Eggerman.

The Member: It will be understood that respondent objects to all questions that follow this line, and the objections will be overruled, and a general exception will [39] be granted.

Mr. Neblett: And based on the specific grounds heretofore raised on it?

The Member: Oh, yes.

Mr. Neblett: In order to protect the government completely in this case, as I understand it, the court is now indicating its intention to overrule any further objections made by respondent along this line?

The Member: That is correct.

Mr. Eggerman: I am quite willing that it be stipulated that your objections are considered to all this line of testimony

(Testimony of Charles H. Howell.)

By Mr. Eggerman:

Q. Tell us whether or not the Northwest Steel Rolling Mills was continuously indebted to your bank from, we will say, 1927, until July 6, 1936.

A. Yes, from 1926 to '36.

Q. Do you recall the maximum amount of that loan? A. $150,000.

Mr. Neblett: May we have on what date?

By Mr. Eggerman:

Q. What period was that?

A. It was in '26, 1926. I just don't recall. I have it there on the books, but it was in 1926.

Q. Now, on the 1st of January, 1936, did the Northwest [40] Steel Rolling Mills still owe the bank? A. Yes.

Q. And approximately in what amount?

A. I would have to refresh my——

Q. Can you tell us approximately?

A. They had paid before the depression came on this loan of $150,000, it was cut down to one hundred twenty-five, and then subsequently to one hundred fifteen, and there it stood for many years. Offhand, I think in '35 they agreed to make a thousand dollars a month reduction. Perhaps that was late in '34.

Q. At that time, do I understand that the indebtedness was about $115,000?

A. $115,000 was where it was when we made this effort to pay $1,000 a month.

Q. How was that loan evidenced, Mr. Howell?

A. A note of the Northwest Rolling Mills Company.

(Testimony of Charles H. Howell.)

Q. What would be the duration or maturity of it? A. Ninety days.

Q. Then it was subject to renewals each ninety days? A. Yes.

Q. Now, tell us whether or not the amount of that loan to the Northwest Steel Rolling Mills during the years that you say it remained unpaid and at about the same amount, was that subject to any criticism on the part of the bank [41] examiner?

A. Yes.

Q. And what about your note committee of the bank?

A. It was discussed rather often during that period when it remained fixed there for so many years, and criticized. I was on the defensive on it. I thought it would eventually work out. I recall one of the times one of the directors on the executive committee wanted to know if there was ever any chance of getting any money on that. I said, "Well, we could get the money by putting them out of business." He didn't want to do that, it was an old account with us, but that is indicative of how our executive committee regarded it, one of the examiners.

Q. Beginning with the first of the year, 1936, was there any monthly payments being received by the bank?

A. We got $1,000 a month, I think; maybe that started somewhat previous to '36, possibly.

Q. In the period that you have described, tell the court what, if any, conditions you as a representa-

(Testimony of Charles H. Howell.)

tive of the bank imposed upon the Northwest Steel Rolling Mills, as a condition to the repeated renewals of this paper?

A. There were two or three instances when they talked to me about some of the capital outlay; I think in one case concerning a piece of property adjoining, and they called me in in two or three instances. They talked to me about [42] getting another furnace that they needed, that they felt they needed in their business, and I told them under no circumstances should they do that until they paid us up.

Q. What, if anything, did you require of the Northwest Steel Rolling Mills to agree to with reference to any available funds over and above the necessary operating expenses?

A. Well, I don't believe we ever had any specific discussion of that. It was understood, of course, that they wouldn't under any circumstances permit——

Mr. Neblett: Objected to.

The Member: I sustain the objection and the answer will go out with reference to what was understood.

By Mr. Eggerman:

Q. Who did you have your conversations with with respect to this paper?

A. Usually with Mr. Herman Goetz.

Q. Ever with Mr. Emil Goetz and Mr. Harry Goetz? A. Yes, Harry Goetz.

(Testimony of Charles H. Howell.)

Q. In your conversations with any of these gentlemen of the Northwest Steel Rolling Mills, did you discuss what use was to be made of any available funds when and if they were available?

A. Well, we would, of course, expect any reduction or any money above operating costs or any profits, to be used towards reduction of our loan.

[43]

Q. Did you make that clear to them?

A. Oh, yes. One case, Mr. Goetz, when things got to going better with him, he thought they were going to be able to pay a dividend, and I says, "Well, you can't consider paying a dividend until you pay this note off."

Q. When was the note finally paid off?

A. I think in July last year, or '36, rather.

Q. 1936? A. Yes.

Q. What would the bank have done had Mr. Herman Goetz violated the instructions that you gave him with respect to disbursing money to the shareholders? A. Put it into receivership.

Cross Examination

By Mr. Neblett:

Q. Mr. Howell, I take it if the petitioner had come in at any time and offered to pay the loan to your bank, the bank would have accepted the loan and returned the note to the petitioner?

A. Gladly.

Q. There isn't any doubt about that?

A. No.

(Testimony of Charles H. Howell.)

Q. So this so-called oral contract restricting dividends could have been wiped out at any time by payment of the loan? [44]

Mr. Eggerman: We object to that as wholly speculative, incompetent, and immaterial.

The Member: Overruled.

A. No, we would have had no further say in it.

By Mr. Neblett:

Q. In the matter? A. No.

Q. If the taxpayer had not elected to proceed and declare a dividend, your bank had no written contract to rely upon in order to stop him, did you?

A. No. I should perhaps qualify that other answer in this way. If they were to continue borrowing operations, we would have had something to say about declaring dividends, even if they had paid us off.

Q. You might not have loaned them any more money, in other words. A. No.

Q. On the contrary, although you had no written contract, you elected to renew the loans from time to time? A. Yes.

Q. And you didn't have any writing from the taxpayer relative to these conversations you had with him about these loans? A. No.

Q. And as I understood you to say in your testimony in [45] chief, there was no specific understanding in respect to any oral agreement respecting this?

Mr. Eggerman: We object to that, if the court please, for the reason that the witness has testified

(Testimony of Charles H. Howell.)

to a specific conversation with Mr. Goetz with respect to dividends.

The Member: He testified to a specific conversation with him with regard to one specific proposal for one specific dividend.

Mr. Eggerman: I think that from the evidence was the only time that Mr. Goetz was ever optimistic enough to think of the possibility of dividends.

By Mr. Neblett:

Q. What is your answer?

A. No, no written agreement.

Q. There was no written agreement that these operating profits were to be used to pay the loans, was there? A. No written agreement.

Mr. Neblett: That is all.

Redirect Examination

By Mr. Eggerman:

Q. When counsel asked you with reference to whetner there was any specific agreement, and you gave the answer "no", did you mean no specific written agreement?

A. No specific written agreement, yes.

Q. You have known Mr. Herman Goetz and the members of [46] his family for a good many years, have you not? A. Yes.

Q. Had you reason to rely upon what they told you? A. Yes.

Q. Did you believe the promises, if any, that they made to you? A. Yes.

(Testimony of Charles H. Howell.)

Q. As the managing officer of the Seaboard Branch, and the man in contact with the Northwest Steel Rolling Mills, tell us whether or not you received periodically financial statements of the Northwest Steel Rolling Mills? A. Yes.

Q. Did you familiarize yourself with those statements from time to time? A. Yes.

Q. During the period you have described, while your note was bearing from $115,000 to $85,000 when it was paid off July 6, 1936, tell us, whether from the financial statements you had of the Northwest Steel Rolling Mills they were in a position to pay dividends?

Mr. Neblett: That is objected to, if Your Honor please.

The Member: Sustained.

Mr. Eggerman: Give us an exception.

The Member: Exception allowed. [47]

Mr. Eggerman: That is all.

Witness excused.

E. A. GOETZ,

called as a witness by and on behalf of the petitioner, having been first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Eggerman:

Q. Are you one of the sons of Mr. Herman Goetz? A. I am.

(Testimony of E. A. Goetz.)

Q. Where is Mr. Herman Goetz today?

A. In the hospital.

Q. In what hospital?

A. St. Luke's Hospital.

Q. And suffering from what malady?

A. Heart attack.

Q. Has he been in failing health for some time?

A. He has.

Q. During the period from 1926 down to and including July 6, 1936, were you connected with the Northwest Steel Rolling Mills yourself?

A. With a short exception.

Q. You have heard the testimony of Mr. Howell, of the bank? A. I have. [48]

Q. Have you personally had anything to do with respect to the obligations owed by the Northwest Steel Rolling Mills to that bank? A. I have.

Q. What, if any, contacts have you had with Mr. Howell yourself?

A. They have been very numerous, executed notes in behalf of the Northwest Steel.

Q. With reference——

A. I talked to him about the general business conditions of the company.

Q. Was that during the period between the time the note was $115,000, testified to by Mr. Howell, and July 6th, 1936?

A. It was between the time that the note—most of my connections were from the inception of the company in 1926 until January 1st, 1934.

(Testimony of E. A. Goetz.)

Q. What if any conversations did you ever have with Mr. Howell at the times these notes were renewed, with respect to the conditions imposed upon the Northwest Steel Rolling Mills, if the notes were to be renewed? What if any conditions were imposed upon your company in conversations with you?

Mr. Neblett: That is objected to, Your Honor.

The Member: Sustained. [49]

A. The money was loaned to us on the condition that the notes were reecived——

The Member: Let that go out. What was said with regard to any condition.

By Mr. Eggerman:

Q. In substance, what did Mr. Howell say?

A. Mr. Howell told us the money was to be used for the current operating expenses only.

Q. What money are you referring to?

A. The money from these notes.

Q. And what did he say with respect to any available monies, as to what the company must do with any available monies if it made them?

A. The money was to be used to reduce the indebtedness.

Q. Well, from 1929 to 1934, the note was not increased, was it, Mr. Goetz? A. No, sir.

Q. Then you received no new money from the bank during those years? A. No, sir.

Q. It was a matter then of trying to repay what had been previously borrowed?

A. That is correct.

(Testimony of E. A. Goetz.)

Q. When you speak about the money that must be used for certain purposes, what money are you referring to, since [50] the money evidenced by the note had been loaned several years prior?

A. Any available money.

Q. Any available money in the treasury of the Northwest Steel Rolling Mills?

A. It was to be used for the current operating expenses only.

Q. And any surplus was to be used for what purpose? A. To repay the indebtedness.

Mr. Eggerman: That is all.

The Member: Any questions?

Cross Examination

By Mr. Neblett:

Q. Just one or two. You stated, Mr. Goetz, that you were with the company except for a short exception. What was the exception and why was it?

A. I was in California for a few months in '34.

Q. How many months?

A. Four months, I think.

Q. Were you disconnected from the business for that period of time? A. Yes, sir.

Q. Do you consider that you could have declared a dividend, Mr. Goetz, if you had wanted to pay the back note off at any time? [51]

Mr. Eggerman: Objected to as wholly speculative. If they were in financial condition to pay the note off, they wouldn't have any note with the bank obviously.

(Testimony of E. A. Goetz.)

The Member: I think that is a little argumentative. I will sustain the objection.

Mr. Neblett: If the note had been paid off, and you wanted to declare a dividend, Mr. Goetz, do you consider that you could have done so?

Mr. Eggerman: The same objection.

The Member: The same ruling. I don't think that counsel for the petitioner would claim that a restriction against dividend would exist after the payment of the notes. Am I correct in that?

Mr. Eggerman: That is quite true, as far as the bank was concerned.

Witness excused.

HARRY L. GOETZ,

called as a witness by and on behalf of the petitioner, having been first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Eggerman:

Q. What period of time, Mr. Goetz, have you been active in the Northwest Steel Rolling Mills?

A. January 2nd, 1934, to the present date. [52]

Q. During that period of time what contacts have you had with the Seaboard Branch of the First National Bank with respect to the corporation's indebtedness to the bank?

(Testimony of Harry L. Goetz.)

A. Oh, we contact the bank probably once or twice a week.

Q. Have you any official position with the company?

A. I am vice-president and general manager today.

Q. And during what period of time were you such officer?

A. I have been the general manager since January 2nd, 1934.

Q. In these conversations with Mr. Howell, would Mr. Howell be the man you would contact?

A. Yes, sir.

Q. What, if anything, was said with respect to the requirements on the part of the bank to the Northwest Steel Rolling Mills?

A. My conversation was with him at the bank at all times, and was that he wanted us to pick up that note, so I agreed with him in January, January 2nd, that we would pay him a thousand dollars a month.

Q. And did you continue those monthly payments? A. Yes, sir.

Q. On July 6, 1936, what was the balance due?

A. $85,000.00. [53]

Q. And was the note paid at that time?

A. The note was paid on July 6.

Mr. Neblett: It is understood that our objection goes to all of this testimony?

The Member: Oh, yes.

(Testimony of Harry L. Goetz.)

By Mr. Eggerman:

Q. How were you able to retire the note on July 6, 1936? Was that out of earnings, or out of reduction of inventories, or how?

A. Our reductions of inventories.

Q. Had the company ever been in a position to pay the bank in full prior to that time?

A. No, sir.

Q. Had it ever been in a position to pay dividends? A. Not that I know of.

Q. It is alleged that the Northwest Steel Rolling Mills was suffering from a deficit? A. Yes, sir.

Q. How long had that deficit been accumulating, if you know?

A. Well, in my recollection, it had been accumulating right along.

Q. From the time you became general manager?

A. After I became general manager, we made no profits. (laughter) [54]

Q. Was the deficit greater when you became general manager than it was the 1st of January, 1936? A. Give me that question again.

Q. Was the deficit greater or less when you became general manager than it was January 1, 1936?

A. It was greater in 1934.

Q. Now, in these conversations with Mr. Howell of the bank, was there anything said by him as to a condition to the renewal of this note as to what must be done with any available monies over and above operating expenses?

A. He was always telling me that "If we have any excess money to pay the notes at the bank."

(Testimony of Harry L. Goetz.)

Mr. Eggerman: I believe that is all.

The Member: Any questions?

Mr. Neblett: No questions.

The Member: That is all.

Witness excused.

HAROLD L. SCOTT,

called as a witness by and on behalf of the petitioner, having been first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Eggerman:

Q. State your name to the court, Mr. Scott.

A. Harold L. Scott. [55]

Q. You are a resident of Seattle?

A. Yes, sir.

Q. And a certified public accountant?

A. Yes, sir.

Q. How long have you been such?

A. Since 1929.

Q. You are the Harold L. Scott who signed the petition in this case? A. Yes, sir.

Q. What connection have you had, Mr. Scott, with the matters involved in this case? What has been your connection with this case from its inception?

A. We have been the auditors for the Northwest Steel Rolling Mills, since the inception of the com-

(Testimony of Harold L. Scott.)

pany, except for a period of, I believe, three years, 1930, 1931 and '32, when no audits were made of the books, as far as I know.

Q. Did your firm prepare the income tax return for the Northwest Steel Rolling Mills for the calendar year 1936? A. Yes, sir.

Q. Have you audited the corporation's books for the year 1936? A. Yes, sir.

Q. Prior thereto. With what degree of familiarity then, can you say that you had with its books, particularly [56] as reflecting its financial position, beginning January 1st, 1936, and throughout that year?

A. I believe that we are familiar with the facts of their operations for that year.

Q. After the filing of the income tax return for that year, what further contact did you have in connection with the tax matters involved in this case?

A. During the fall of 1937 the internal revenue agent's office had Mr. Larson make an examination of the company's books, and the agent's report is dated September 25, 1937, forwarded to the taxpayer under the date of October 1st, 1937.

Q. And by whom is that report signed?

A. George C. Early, Internal Revenue Agent in charge.

Q. Tell us whether or not there are exhibits forming a part of that report. A. There are.

Q. Those are exhibits "A" and "A-1", are they not? A. They are included in the report.

(Testimony of Harold L. Scott.)

Q. Have you the original of Mr. Early's Exhibit "A" and "A-1"?

A. I have the copy that was mailed to the taxpayer. It is a carbon, but that is the only copy that the taxpayer received from the——

Q. Will you detach that and hand it to me, Mr. Scott? [57] I am referring to Exhibits "A" and "A-1". What subsequently occurred, Mr. Scott, with reference to the tax matter, after the receipt of that letter or that report, I should say?

A. I believe a protest was filed, and the case was forwarded to Washington, and the ninety-day letter was issued.

Q. Have you the letter from the Commissioner?

A. Yes, sir.

Q. Will you produce it?

A. Yes, sir. I have the Commissioner's letter dated February 4, 1938.

Q. Now, on reciept of Exhibits "A" and "A-1", and the letter of the Commissioner, dated February 4, 1938, did you examine the compilation with respect to the financial position of the Northwest Steel Rolling Mills during the year 1936, as stated in those two documents?

A. Yes, sir, and we agreed to it.

Mr. Neblett: That is objected to, Your Honor, as improper, as calling for an improper interpretation of the agent's report.

The Member: The question is, did he look into the financial condition of the company.

(Testimony of Harold L. Scott.)

Mr. Neblett: No objection.

The Member: All right. You may answer.

Q. Yes, I—on the schedule, Exhibit "A" it shows [58] the deficit at the beginning of the period, as amended, to be $76,000——

Mr. Neblett: Just a minute. Objected to, Your Honor.

The Member: Not responsive to the question.

Mr. Neblett: We——

The Member: It goes out as not responsive to the question.

By Mr. Eggerman:

Q. Is there any difference in the figures submitted by you as the accountant and C. P. A. and the compilation of figures in the documents "A", "A-1", and the Commissioner's letter?

Mr. Neblett: That is objected to.

The Member: Objection sustained, calling for a conclusion.

Mr. Eggerman: Give us an exception.

The Member: Exception is noted.

By Mr. Eggerman:

Q. Did you take any issue with the compilation of figures in the agent's report or in the Commissioner's letter?

Mr. Neblett: Objected to, Your Honor——

The Member: Objection sustained, on the ground it is irrelevant and immaterial.

By Mr. Eggerman: [59]

Q. Do you at this time make any issue as to the correctness of those figures?

(Testimony of Harold L. Scott.)

Mr. Neblett: I want to make this express suggestion, that question is asked for the sole purpose of circumventing your ruling.

The Member: The same objection, the same ruling.

Mr. Eggerman: I will state into the record that the petitioner adopts and has always adopted the same figures as shown in "A" and "A-1"——

Mr. Neblett: Are you *re*stifying? If you want to testify you take the stand.

The Member: Go ahead.

Mr. Eggerman: I object to counsel interrupting me.

(Mr. Eggerman's statement was read.)

Mr. Eggerman: —and the Commissioner's letter dated February 4, 1938, and adopts those figures for the purpose of this hearing.

The Member: Any other questions of this witness?

Mr. Eggerman: Yes.

By Mr. Eggerman:

Q. Have you the general ledger?

A. It is here in the room, yes, sir.

Q. Will you take the general ledger then, Mr. Scott? A. Yes.

The Member: Gentlemen, would it help at all—it is my [60] understanding that if the books are here and the government's accountant is here, and the petitioner's accountant is here, if there is any question with regard to figures, it seems to me it would be possible to get together on it. If it would help any, I will recess, gentlemen, and you can have

(Testimony of Harold L. Scott.)

a conference with regard to it, and the respondent can examine the petitioner's books here with regard to those figures.

Mr. Neblett: We will be very glad to try, Your Honor.

Mr. Eggerman: We understood that they had agreed.

The Member: I thought that it could be done in a short length of time. Do you have any other witnesses on any other point, except the financial condition of the company?

Mr. Eggerman: No, that is all.

The Member: Is the respondent going to introduce any witnesses? Is the corporate charter in evidence?

Mr. Eggerman: It is stipulated, if Your Honor please. We have the charter available.

The Member: I didn't know any stipulation had been filed.

Mr. Eggerman: The stipulation, counsel said he agreed that the taxpayer was a corporation, chartered under the general laws of the State of Washington, receiving a charter in the year 1926.

The Member: But the charter itself is not in evidence?

Mr. Eggerman: No, the charter is not in evidence. [61]

The Member: And I mention the fact for fear it was an oversight on the part of counsel.

Mr. Eggerman: I am quite willing to submit a copy of the charter if counsel is agreeable.

(Testimony of Harold L. Scott.)

The Member: I am not insisting. I thought it might have been an oversight in view of the fact that the stipulation was not adopted in whole.

The respondent has no further evidence?

Mr. Neblett: The respondent may want to introduce a return for the Northwest Steel Rolling Mills, Inc., but that won't take a minute.

The Member: I would suggest that it might be in the interest of time to continue this case, and give you a chance to have a little mutual auditing done.

Mr. Scott: I would suggest Wednesday morning.

The Member: I would rather not make it Wednesday. I will continue this matter until Tuesday morning.

Mr. Eggerman: At this time, if Your Honor please, I would like to submit and leave with Mr. Neblett, if he desires, the original Articles of Incorporation. I think it would probably be more help to the court. I will offer them in evidence, and ask the court, however, for the privilege of substituting a copy.

The Member: The exhibit will be admitted in evidence, and leave granted to substitute therefor a copy. [62]

Mr. Eggerman: And along with that we offer in evidence the authorization from the state of Washington, and statement of the filing of these Articles as of February, 1926, and request leave to substitute a copy.

(Testimony of Harold L. Scott.)

The Member: It will be admitted.

(The said Articles of Incorporation, and Certificate from the Department of State, so offered and received in evidence, were marked Petitioner's Exhibits 3 and 4 respectively, and made a part of this record.)

PETITIONER'S EXHIBIT 3

ARTICLES OF INCORPORATION OF NORTHWEST STEEL ROLLING MILLS, INC.

Know All Men by These Presents:

That we, Abe Goldberg, E. A. Goetz and James R. Stirrat, Jr., all being citizens of the United States and of the State of Washington and residing in the City of Seattle, Washington, do hereby associate ourselves together for the purpose of forming a corporation under the general incorporation laws of the State of Washington, to be known as "Northwest Steel Rolling Mills, Inc.," and for that purpose we do hereby certify and adopt the following, in triplicate, as our Articles of Incorporation:

Article I.

That the corporate name of this corporation shall be: Northwest Steel Rolling Mills, Inc.

Article II.

That the purposes and objects for which this corporation is formed are:

(Testimony of Harold L. Scott.)

First: To engage in the general steel rolling mill business and in the general steel and iron business; to purchase or otherwise acquire, construct, own, operate, sell and dispose of steel mills and plants; to manufacture, buy, sell and deal in rails, structural steel, shapes, forms, bolts, nuts and any and all steel and iron products and/ [70] or by-products, and to engage in every kind of trade or business incident thereto, including the purchase and sale of iron ores or minerals, pig iron, steel, steel ingots, scrap iron and scrap steel, coal, coke, manganese, and all other products necessary or convenient to be used in carrying on any of the branches of the business above set forth; to engage in the general steel furnace and iron ore smelting and reduction business, and the refining of iron ores and other minerals, and the production of pig iron, steel ingots and other similar products.

Second: To acquire by grant, purchase or otherwise, to own, hold, lease, prospect, develop, operate and manage, and to sell, convey, transfer, let or encumber mines, mineral locations and claims, lands containing coal and minerals, both base and precious, and mineral rights and privileges of every kind or character; and also to locate, appropriate, claim and acquire by patent or otherwise mining claims and mining rights and privileges, including mill sites and water rights from the United States or any other governmental authority, foreign or domestic, in the manner provided by law.

(Testimony of Harold L. Scott.)

Third: To acquire by grant, purchase, lease or otherwise, to construct, own, manage and operate and to convey, let or encumber mining, milling, concentrating, smelting, reduction, refining and washing plants for the mining, treatment and reduction of ores, minerals and coal and coke, together with all kinds of real and personal property, easements and privileges appertaining to said property and necessary or convenient to be used in connection therewith, and generally to transact and carry on any and all kinds of business in any manner connected with or incidental to the treatment of ores, minerals, coke and coal. [71]

Fourth: To acquire by purchase or lease, own, manage, improve, and to convey, let or encumber real and personal property of every kind, including timber and timber lands, tide lands, water front property, shore and riparian rights, bunkers, warehouses, docks, piers and wharves; and also to appropriate and acquire real property and rights and privileges of every kind therein from the United States, or any foreign governmental authority in accordance with the public laws thereof.

Fifth: To build, purchase, charter or otherwise acquire, to manage and operate and to transfer, let or encumber any and all kinds of steam and motor vessels, tug boats, barges, scows or other water craft, and to engage in a general transportation business therewith upon the waters of Puget Sound, British Columbia and Alaska, and the tributaries thereof.

(Testimony of Harold L. Scott.)

Sixth: To build, purchase, lease or otherwise acquire, and to equip, manage and operate railways, by steam, electricity or other power, and to convey, let or encumber the same, and to carry on and conduct a general transportation business as a private carrier.

Seventh: To acquire by purchase, grant or lease and to build, equip, operate, convey, let or encumber, trams, tramways, roads, trails and other private thoroughfares and all other means, equipment or devices for the conveying and handling of ores or minerals, and all supplies used in connection with the mining and smelting business.

Eighth: To acquire by purchase, lease or otherwise, to build, equip, manage and operate, and to convey, let or encumber canals, dams, ditches, sluices, flumes, acqueducts, reservoirs and other means of conveying and utilizing water for mining, reduction, power, transportation [72] and other useful purposes, including the acquisition and control of water rights under national, state, provincial, territorial or district laws.

Ninth: To acquire by grant, purchase or otherwise, and to plat, subdivide, sell, convey, lease or encumber townsites and the lots, blocks or subdivisions thereof, including the right to enter townsites under the Public Land Laws of the United States and to obtain title thereto.

Tenth: To acquire by purchase, lease or otherwise, to build, equip, manage and operate, and to convey, let or encumber power plants and plants for

(Testimony of Harold L. Scott.)

the manufacture and development of electricity for light, power, heat and other useful purposes, together with poles, wires, mains, conduits, circuits and all necessary equipment therefor, and to sell and supply electricity, heat, light or power to other persons or corporations.

Eleventh: To conduct and carry on the general business of merchants, manufacturers and dealers, and to buy, sell, bargain, change and deal in every kind of goods, wares and merchandise.

Twelfth: To acquire other businesses, whether conducted by corporation, association, partnership or individuals, and the good will, assets and property thereof, and to undertake and assume the whole or any part of the obligations of such corporation, association, partnership or individuals.

Thirteenth: To enter into any lawful arrangement for sharing profits, union of interests, reciprocal concession, or co-operation with any person, association, partnership or corporation carrying on or about to carry on any business which this corporation is authorized to carry on, so [73] as to directly or indirectly benefit this corporation.

Fourteenth: To borrow money for the business of the corporation and to give security therefor, and to that end to execute bonds, debentures, promissory notes or other evidences of indebtedness, and to secure the same by deed of trust, mortgage or pledge, of all or any part of the property of the corporation.

(Testimony of Harold L. Scott.)

Fifteenth: To exercise the right of eminent domain for any of the corporate purposes herein expressed whenever authorized by law relating thereto.

Sixteenth: To purchase or otherwise acquire, own, hold, sell or transfer the stocks, bonds or other evidences of interest in or obligation of any other person or corporation.

Seventeenth: To issue and exchange the paid up capital stock of this corporation, preferred and/or common, in payment for, at the reasonable value thereof, real and personal property and other assets of any existing business, whether corporate or otherwise, which is carrying on and conducting any of the branches of the business herein authorized to be carried on and conducted by this corporation.

Eighteenth: To buy or otherwise acquire, sell, lease or otherwise dispose of and deal in letters patent of the United States or of any foreign country, licenses, inventions, trade marks, trade names or secret processes and formulas useful or convenient in carrying on any of the branches of the business herein specified.

Nineteenth: To exercise such powers as are or may be granted or conferred by the general incorporation laws of the State of Washington, [74] and to do and perform all things necessary, proper or convenient for the carrying out of the objects and purposes herein specified.

Twentieth: In addition to the objects and purposes aforesaid, this corporation is formed for the

(Testimony of Harold L. Scott.)

purpose of engaging in and carrying on the business and exercising the powers hereinbefore specified outside of the State of Washington, and particularly in the District of Alaska and the Province of British Columbia, and for that purpose it is authorized to comply with the laws of the District of Alaska, or of any territory or district of the United States, or of any foreign province or territory in relation to foreign companies doing business therein.

Twenty-first: The foregoing clauses shall be construed both as objects and powers, and it is hereby expressly provided that the foregoing enumeration of specific powers shall not be held to limit or restrict in any manner the general powers of this corporation.

Article III.

At any time after the expiration of three years from the date of this incorporation, the Trustees of this corporation, upon being authorized so to do by a majority of the stockholders thereof, shall have the right to sell and dispose of all the property and assets of this corporation at a fair price therefor as fully and to the same extent as though such sale was authorized by the unanimous vote of all the stockholders of this corporation.

Article IV.

The capital stock of this corporation shall be two hundred thousand dollars ($200,000) divided into two thousand (2,000) shares of the par value of one hundred dollars ($100.00) each. [75]

Article V.

That the time of the existence of this corporation shall be fifty years from and after the date of its incorporation.

Article VI.

That the number of Trustees of this corporation who shall manage the concerns of this corporation until the second Monday of May, 1926, shall be four and their names and addresses are: Abe Goldberg, James R. Stirrat, Herman Goetz and C. F. Riddell, all of the City of Seattle, in the State of Washington.

The stockholders of this corporation may, at any annual meeting thereof, or at any special meeting called for that purpose, by a majority vote increase the number of Trustees of this corporation to any number not exceeding nine (9) without the necessity of amending these Articles therefor.

Article VII.

The principal office and place of business of this corporation shall be in the City of Seattle, County of King and State of Washington, but meetings of the Board of Trustees may be held outside of said State of Washington at such place or places as may from time to time be provided by resolution of the Board of Trustees of this corporation or by the By-laws of this corporation.

In Witness Whereof, we, the incorporators above named have hereunto set our hands and seals to

(Testimony of Harold L. Scott.)

these presents, in triplicate, this 11th day of February, 1926.

(Signed) ABE GOLDBERG, [Seal]
E. A. GOETZ [Seal]
JAMES R. STIRRAT [Seal]

[76]

State of Washington,
County of King—ss.

This is to certify, that on this 11th day of February, 1926, before me, the undersigned, a Notary Public in and for the State of Washington, duly commissioned and sworn, personally came Abe Goldberg, E. A. Goetz and James R. Stirrat, Jr., to me known to be the individuals described in and who executed the within Articles of Incorporation, and acknowledged to me that they signed and sealed the same as their free and voluntary act and deed, for the uses and purposes therein mentioned.

Witness my hand and official seal, the day and year in this certificate first above written.

Signed J. E. PETERSON,
Notary Public in and for the State of Washington, residing at Seattle.

[Endorsed]: Admitted in evidence Sept. 27, 1938.

[77]

(Testimony of Harold L. Scott.)

PETITIONER'S EXHIBIT 4

S. F. No. 1421—1922 Approved as to Form by Department of Efficiency. 721.

The Seal of the State of Washington 1889

Article No. 60181 Domestic

Department of State
Olympia
Office of the
Secretary of State

I, J. Grant Hinkle, Secretary of State of the State of Washington, do hereby certify that Articles of Incorporation of the Northwest Steel Rolling Mills, Inc., a Domestic Corporation, of Seattle, Washington, were, on the 13th day of February, A. D. 1926, at 9:06 o'clock A. M., filed for record in this office and now remain on file herein, being duly recorded in Book 139, at page 388, Domestic Corporations.

In Testimony Whereof, I have hereunto set my hand and affixed hereto the Seal of the State of Washington.

Done at the Capitol, at Olympia, this 20th day of March, A. D. 1926.

[Seal] J. GRANT HINKLE,
Secretary of State.

By (s) A. M. KITTO,
Assistant Secretary of State.

[Endorsed]: Admitted in evidence Sept. 24, 1938.

[78]

Mr. Neblett: The respondent would like to stipulate and place in the record right now that the Northwest Steel Rolling Mills, Inc., for the calendar year 1936, filed a return, and that return shows surplus by appraisal at the beginning of 1936, $134,-173.90, and at the end of the year, 1936, $134,173.90.

The Member: No objection to that offered stipulation? Is it agreeable to you?

Mr. Eggerman: I am leaving that to Mr. Scott.

Mr. Scott: Yes, that is agreeable.

The Member: The record will show those figures as stipulated by and between the parties

Mr. Neblett: Could I find out what the number of the petitioner's exhibits are, and what they are?

The Member: The ones that have been admitted are 3 and [63] 4 having to do with the corporate charter and certain documents executed by the State of Washington on the occasion of the granting of the charter, as I understand it. 1 and 2 were the agent's report and the ninety-day letter, were they not?

Mr. Eggerman: Yes, sir. They were not admitted in evidence.

The Member: That is all of the evidence on the part of both petitioner and respondent, with the exception of certain matters having to do with the interpretation of the books of the company?

Mr. Neblett: That is correct, Your Honor.

The Member: And I understand that the parties will be able to, after an examination of the books, stipulate probably, in all probability, as to the books of the company?

Mr. Neblett: I think that is correct, Your Honor.

Mr. Scott: There is only one question involved. That is the amount of the deficit.

The Member: I ask that because I don't want to spend any time at all with this Tuesday morning, because I have a case set on that morning that will take all day, and also a case which has been continued for the completion of evidence to that morning, but this case will be continued until the morning of Tuesday, September 27th, at 9:30.

Mr. Eggerman: If Your Honor please, in the event, which [64] I think is remote, I cannot stipulate, I will offer in evidence 1 and 2 Tuesday morning. I think it is unnecessary to encumber the record prior to that. They can be stipulated.

The Member: We will take a recess.

(Whereupon, at 11:30 o'clock a. m., the hearing in the above entitled matter was adjourned to Tuesday, September 27, 1938, at 9:30 o'clock a. m.) [65]

REPORTER'S MINUTES

Hearing at Room 117 Federal Office Building on the 27th day of September, 1938, at 9:30 o'clock *p.*m.

The above-entitled proceeding came on for hearing on this the 27th day of September, 1938, before the Honorable John W. Kern, Member of the United States Board of Tax Appeals, at Seattle, Washington, pursuant to notice of hearing hereto-

fore given; whereupon the following proceedings were had and testimony heard, to-wit:

Appearances:

H. L. Scott, Esq., (Exchange Bldg., Seattle, Wash.) Appearing on behalf of Petitioner.

Donald G. Eggerman, 1824-27 Exchange Bldg., Seattle, Wash., appearing on behalf of Petitioner.

B. H. Neblett, Esq., (Honorable J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue), appearing on behalf of the Commissioner of Internal Revenue, Respondent. [66]

PROCEEDINGS

The Member: The other case is the Northwest Steel Rolling Mills.

Mr. Eggerman: May the record show, if the Court please, in accord with your Honor's opinion Saturday that we are now substituting the copy of the articles of incorporation which is Exhibit 3, I believe.

Mr. Neblett: I have no objection, your Honor.

The Court: All right. Leave will be granted for substituting.

The Clerk: One and two weren't admitted.

Mr. Eggerman: No. they haven't been offered yet.

The Member: Now, will counsel acquaint me with what is before the Board at the present time?

Mr. Neblett: Well, if your Honor please, when we adjourned the last time the question about the

amount of operating deficits was the only question left undetermined then.

The Member: Yes.

Mr. Neblett: The respondent now stipulates that the petitioner had an operating deficit as of December 31, 1935, of $76,983.26.

The Member: That stipulation is agreed to by the petitioner? [67]

Mr. Scott: It is.

The Member: Is there anything else, gentlemen, in regard to this case?

Mr. Scott: Yes, I believe that we should stipulate that the taxable income for the year 1936 was $76,049.71.

Mr. Neblett: I think that has already been done. Let me check that one thing.

The Member: Yes.

Mr. Neblett: It may be so stipulated, your Honor.

The Member: All right. Is there anything else now? If that is all, gentlemen, the clerk will announce the date of filing briefs, and I think you may add, if there is no objection, on account of the number of these cases that are coming up, it will relieve the congestion on the part of the respondent's counsel and I think it will probably be a convenience to him if we add 30 days to the usual time of filing of briefs if there is no objection on the part of petitioner.

Mr. Eggerman: No objection.

The Clerk: Petitioner's brief is due November 26th. Respondent's brief is due January 25th. Petitioner's [68] answer is due February 9th.

Mr. Neblett: Your Honor, before we proceed could I ask Mr. Scott to read off that income figure once more so that I can have a double check on that figure?

Mr. Scott: $76,049.71.

Mr. Neblett: That is O.K.

(Hearing Concluded) [69]

[Title of Board and Cause.]

PRAECIPE FOR RECORD ON APPEAL

To: Clerk of the United States Board of Tax Appeals:

You Will Please Prepare, transmit, and deliver to the Clerk of the United States Circuit Court of Appeals for the 9th Circuit, copies duly certified as correct of the following documents and records in the above entitled cause in connection with the petition for review by the said Circuit Court of Appeals for the 9th Circuit, heretofore filed on behalf of Northwest Steel Rolling Mills, Inc.:

(1) Docket entries;

(2) Pleadings,
   (a) Petition
   (b) Answer to Petition
   (c) Stipulation of Facts;

(3) Transcript of evidence and proceedings at hearing;

(4) Memorandum Findings of Fact and Opinion, entered February 16, 1939;

(5) Decision;

(6) Petition for Review;
(7) Notice of Filing Petition for Review;
(8) Praecipe for Record;
(9) Exhibits 3 and 4.

D. G. EGGERMAN,
Counsel for Appellant. [79]

Service of a copy of the within Praecipe, together with a copy of the proposed Transcript of Evidence and Proceedings on Hearing, is hereby admitted this 5th day of May, 1939.

J. P. WENCHEL,
Counsel for Respondent.

[Endorsed]: U.S.B.T.A. Filed May 31, 1939. [80]

[Title of Board and Cause.]

CERTIFICATE

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 80, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 12th day of June, 1939.

[Seal] B. D. GAMBLE,
Clerk, United States Board of Tax Appeals.

[Endorsed]: No. 9207. United States Circuit Court of Appeals for the Ninth Circuit. Northwest Steel Rolling Mills, Inc., Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the United States Board of Tax Appeals.

Filed June 17, 1939.

PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

United States Circuit Court of Appeals

No. 9207

NORTHWEST STEEL ROLLING MILLS, INC., a corporation,

Petitioner on Review,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent on Review.

DESIGNATION OF POINTS ON APPEAL AND OF RECORD TO BE PRINTED.

To: Hon. Paul P. O'Brien, Clerk, United States Circuit Court of Appeals:

You will please be advised that Northwest Steel Rolling Mills, Inc., Petitioner on Review, designates as the points on which it intends to rely on the appeal, the following:

I.

That the Board of Tax Appeals erred in entering a decision for Respondent, resulting in a deficiency against Petitioner in the sum of $13,628.22.

II.

That the Board of Tax Appeals erred in holding that the charter and general corporation laws of the State of Washington are not a written contract within the meaning of Section 26 of the Revenue Act of 1936.

III.

That the Board of Tax Appeals erred in denying Petitioner's contention that Section 26 of the Revenue Act of 1936 is invalid and unconstitutional, insofar as it relates to Petitioner and to Petitioner's charter and contract with the State of Washington under which it is incorporated.

IV.

That the Board of Tax Appeals erred in refusing to sustain Petitioner's contention that Section 26 of the Revenue Act of 1936 is unconstitutional and in violation of the Fifth Amendment of the Constitution of the United States of America because it grants an exemption to a corporation obligated with regard to the non-payment of dividends under a written contract while it withholds such exemption from a corporation similarly obligated under an oral contract.

V.

That the Board of Tax Appeals erred in failing to redetermine Petitioner's income tax and surtax for the calendar year 1936 and to decide that there was no deficiency for said year.

VI.

That the Board of Tax Appeals erred in that its decision is not supported by the evidence and stipulation of facts and is contrary to law.

That Petitioner on Review designates the entire record as being necessary for the consideration of the appeal herein.

Dated this 22d day of June, 1939.

W. S. LEATHOUSE,
Counsel for Petitioner on Review, Northwest Steel Rolling Mills, Inc.

[Endorsed]: Filed June 24, 1939.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

Excerpt from Proceedings of Tuesday, December 5, 1939

Before GARRECHT, HANEY, and STEPHENS, Circuit Judges

Order of submission

Ordered petition to review in above cause argued by Mr. Walter S. Greathouse, counsel for petitioner, and by Mr. James P. Garland, Special Assistant to the Attorney General, counsel for respondent, and submitted to the court for consideration and decision.

Upon consideration of the application of Messrs. Robert L. Judd and Harry O. Glasser to file brief as Amici Curiae herein, and good cause therefor appearing, ordered application granted, and brief ten[d]ered therewith filed.

United States Circuit Court of Appeals for the Ninth Circuit

Excerpt from Proceedings of Friday, March 1, 1940

Before GARRECHT, HANEY, and STEPHENS, Circuit Judges

Order directing filing of opinion and dissenting opinion, and filing and recording of judgment

By direction of the Court, ordered that the typewritten opinion and dissenting opinion this day rendered by this court in above cause be forthwith filed by the clerk, and that a judgment be filed and recorded in the minutes of this court in accordance with the majority opinion rendered.

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 9207. Mar. 1, 1940

NORTHWEST STEEL ROLLING MILLS, INC., PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Upon Petition to Review a Decision of the United States Board of Tax Appeals

Before GARRECHT, HANEY, and STEPHENS, Circuit Judges.

STEPHENS, Circuit Judge: This appeal involves the question of the validity of a levy of a surtax under the Revenue Act of 1936 [c. 690, 49 Stat. 1648] upon the undistributed profits of the taxpayer. The

taxpayer contends that it is entitled to a credit under Section 26 of the Act, which reads in part as follows:

"Sec. 26. Credits of Corporations.

"In the case of a corporation, the following credits shall be allowed to the extent provided in the various sections imposing tax— * * *

"(c) Contracts restricting payment of dividends—

"(1) Prohibition on payment of dividends—An amount equal to the excess of the adjusted net income over the aggregate of the amount which can be distributed in the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. * * *

"(2) Disposition of profits of taxable year—An amount equal to the portion of the earnings and profit of the taxable year which it is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt); to the extent that such amount has been so paid or set aside. * * *"

Taxpayer is a Washington corporation, with its principal place of business in that State. From 1926 to 1936 the taxpayer was indebted to a Seattle bank, which indebtedness was evidenced by 90-day notes which were renewed from time to time. The original indebtedness amounted to $150,000.00, but by January 1934, it had been reduced to approximately $115,000.00. In January 1934, when the taxpayer proposed to renew the notes the bank officers conditioned the renewal of the notes on the payment by the taxpayer of $1,000 a month in reduction of the principal amount thereof, together with the payment on the indebtedness of any available surplus in taxpayer's treasury after the payment of its current operating expenses. Taxpayer was given to understand by the bank that any breach of this condition would result in the bank's having a receiver appointed for the taxpayer's assets. This condition to the renewal of these notes was not reduced to writing. From January 1934, to July 1936, the amount of taxpayer's indebtedness to the bank was reduced to the sum of $85,000.00, and this amount was paid on July 6, 1936.

Throughout the year 1936 the general incorporation laws of the State of Washington provided in part as follows [Uniform Business Corporation Act, Laws of 1933, p. 785, sec. 24, of the State of Wash.; Rem. Rev. Stat. 3803–24]:

"In computing the aggregate of the assets of the corporation, the Board of Directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off, at least annually in proportion to their use as may be determined by the Board of Directors.

"4. No corporation shall pay dividends,

"a. In cash or property, except from the surplus of the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets; * * *"

As of December 31, 1935, the taxpayer's operating deficit was $76,983.26. Its net income for 1936 was $76,049.71. At the beginning of the year 1936 the taxpayer had a surplus by appraisal of $134,173.90.

Taxpayer first relies upon the oral contract with the bank under which it agreed to apply all available surplus to the principal of its notes. The contention is that the Revenue Act unreasonably discriminates between written and oral contracts expressly providing for disposition of earnings and profits in discharge of a debt, and that it therefore violates the Fifth Amendment of the United States Constitution. We think there is a rational basis for the distinction between written and oral contracts. As stated by the respondent in its brief, "It is a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether an ordinary written contract prohibits payment of dividends. But it would be an almost insuperable burden for the Bureau to determine the validity and scope of oral contracts of that nature."

Taxpayer next relies upon the Washington statutes prohibiting payment of dividends except out of profits. The contentions are, first, that the Congress intended to include a corporate charter as a "written contract," and, second, that if the Act is construed not to include a corporate charter as a written contract, the Act is unconstitutional.

The respondent argues that the taxpayer has failed to prove that it could not legally have paid dividends during the taxable year 1936. It points to the "surplus by appraisal" at the beginning of 1936, and states in its brief, "Certainly the mere fact that taxpayer had an operating deficit at the beginning of the year would not prevent it from declaring dividends out of its profits during the taxable year so long as it had sufficient surplus and the record does not show that it did not. * * * the record does show 'surplus by appraisal' of some $134,000 and that would be more than sufficient to cover a dividend of $76,000 unless such surplus was created by 'unrealized appreciation in value or revealuation of fixed assets' and the record does not show that it was."

We think that the taxpayer has proved that it could not have legally paid the dividends. There is no dispute but that the deficit had accumulated from January 2, 1934. And furthermore, the taxpayer's vice-president and general manager testified:

"Q. Had the company ever been in a position to pay the bank in full prior to that time?

"A. No, sir.

"Q. Had it ever been in a position to pay dividends?

"A. Not that I know of."

Respondent's claim that this evidence cannot be considered because of the fact hat it is a conclusion of the witness is without merit, as the evidence was admitted without objection, and being undisputed it constitutes proof of the fact.

This brings us to a consideration of the question of whether the Revenue Act of 1936 should be construed as including taxpayer's charter as a "written contract executed by the corporation prior to May 1, 1936" which "expressly deals with the payment of dividends."

It is contended by the respondent that even assuming that the charter might be construed to be a "contract executed by the corporation," it does not "expressly deal with" the payment of dividends. This was the holding of the Circuit Court of Appeals for the Eighth Circuit in Crane-Johnson Co. v. Commissioner, 105 Fed. (2d) 740 (1939), wherein the court said that "if there is such a contract, it is not an express one, but is implied."

In our opinion the Crane-Johnson case confuses the wording of the statute in question, that is, "a written contract executed by the corporation prior to May 1, 1936 which provision expressly deals with the payment of dividends."

It is settled law that—

"Laws which subsist at the time and place of the making of the contract, and where it is to be performed, enter into and form a part of it, as fully as if they had been expressly referred to or incorporated in its terms."

Farmers Bank v. Fed. Reserve Bank, 262 U. S. 649, 660. See also Von Hoffman v. Quincy, 4 Wall. 535, 550.

Aside from that, the taxpayer's articles of incorporation "expressly" refer to the general incorporation laws of the State of Washington, as follows:

"That the purposes and objects for which this corporation is formed are:

* * * * * * *

"Nineteenth. To exercise such powers as are or may be granted or conferred by the general incorporation laws of the State of Washington * * *."

The object of our search, therefore, is to see whether or not the laws of the State of Washington, which are so incorporated into the taxpayer's character, "expressly deal(s) with" the payment of dividends.

It is suggested that since the law is general and does not refer in particular to the taxable year in question, it does not comply with the wording of the statute requiring the contract to "expressly deal with the payment of dividends." This construction of the statute is too narrow. The mere fact that the statute prohibits the payment of dividends during any year in which there is a deficit, certainly cannot militate against the idea that the statute "expressly" deals with the disposition of profits during the year in question. See G. B. R. Oil Corporation v. Commissioner, 40 B. T. A. 737.

It is argued that in any event, the corporate charter cannot be construed to be a "written contract executed by the corporation prior to May 1, 1936" within the meaning of the statute.

At the outset it should be mentioned that the date of incorporation was some ten years prior to 1936, therefore there is no difficulty as to this portion of the quoted clause.

The principle that a corporate charter is a contract between the state and the corporation and its members was established in Trustees of Dartmouth College v. Woodward, 4 Wheat. (U. S.) 518, 4 L. Ed. 629, and has been reaffirmed many times. The argument, however, is that the articles of incorporation are not "executed by the corporation" but are executed by its incorporators, and that the incorporators are not agents of the corporation since there cannot be an agency before the existence of the principal.

Be that as it may, the fact remains that by accepting the corporate charter, the corporation became bound by the acts of the incorporators in so executing the articles, whether we rely upon a theory of novation, ratification, or continuing offer.

It is worthy of note that the law of the State of Washington is that a corporation may "ratify" the preorganization contracts of its incorporators and thus become a party to the contract. See Walnut Park Lumber & Coal Co. v. Roane et al., 17 Pac. (2d) 896, 898 (Wash. 1933) wherein the court said,

"If promoter Kelly, who later became manager and president of the corporation, made contracts, prior to incorporation, in the interests of the corporation, and those contracts were approved by the company subsequent to incorporation, such ratification is binding upon the corporation."

We do not believe that Congress intended the word "executed" to have such a narrow meaning as to exclude the act of becoming bound by ratification. As stated in 23 Corpus Juris 278,

"The words 'execute,' 'executed,' and 'execution,' when used in their proper sense, convey the meaning of carrying out some act or course of conduct to its completion. Thus when the terms are applied to a written instrument, they include the performance of all acts which may be necessary to render it complete as an instrument importing the intended obligation, of every act required to give the instrument validity or to carry it into effect or to give it the forms required to render it valid."

The Supreme Court has said that a statute should be construed to avoid not only the conclusion that it is unconstitutional, but also grave doubts as to its constitutionality. Linder v. U. S. 286 U. S. 5, 17.

This impels the conclusion that the Act in question should be construed so as to include the taxpayer's corporate charter within the term "written contract executed by the corporation, etc." There seems to be grave doubts as to whether there is a reasonable basis for

discrimination between a written contract actually "signed" by a corporation prohibiting the payment of dividends, and the contract of the charter to which the corporation is as fully bound, likewise prohibiting the distribution of profits. The "administrative convenience," which we have above held lends a basis for the distinction between oral and written contracts, would not seem to apply with equal force to this situation.

In the view that we take of the case it is unnecessary for us to consider the remaining contention of the taxpayer, that the Act is an attempt to control distribution of profits, a matter reserved to the states by the Tenth Amendment of the Constitution; and the contention of amici curiae that the tax is on the stockholder's share in the taxpayer's accumulated profits which is not authorized by the Sixteenth Amendment.

Reversed.

HANEY, Circuit Judge, dissenting.

Elaborate argument may be made that as a general rule the charter of a corporation is considered to be a contract [1] in certain branches of the law in order to bind a corporation for acts of its promoters, but I believe such an argument is inapposite here. A question as to the liability of a corporation for the acts of a promoter, or for violation of its charter, is not presented. The question presented is whether a corporate charter is "a written contract executed by the corporation" within the meaning of Sec. 26 (c) (1 and 2) of the Revenue Act of 1936.

It is clear that the quoted words might have been used in either of two senses, i. e. (1) a written contract "binding on" the corporation; or (2) a written contract "signed by" the corporation. The majority hold that the first sense was intended. I disagree, because such a construction renders the words "executed by" superfluous. Had such words been intended in the sense of "binding on" such idea would have been as fully expressed by simply saying "a written contract of a corporation." If there was a contract, it was binding on the corporation, and it was unnecessary to say more. Furthermore, had such sense been intended, it could and, I believe, would have been expressed unambiguously by saying "a written contract binding on the corporation." It seems clear to me that the construction given the words "executed by" by the majority renders them superfluous and meaningless.

One rule of statutory construction is stated in Platt v. Union Pacific R. R. Co., 99 U. S. 48, 58, that

"* * * a legislature is presumed to have used no superfluous words. Courts are to accord a meaning, if possible, to every word in a statute * * *"

I believe the construction of the majority violates that rule. On the other hand, the word "executed" is given significance by construing

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[1] See 3 Paul & Mertens, Law of Federal Income Taxation, Sec. 32A.43 (p. 352 et seq. 1938 Cum. Supp.).

it as being used in the sense of "signed." I believe that meaning should be given to the word here.

In this connection, both parties rely on the legislative history of the statute. I think such history is not helpful here because considerable revision of proposed bills leading to enactment of the statute in question was made "in conference without any new statement of legislative intent." 3 Paul & Mertens, Law of Federal Income Taxation Sec. 32A.01 (1938 Cum. Supp.).

Independently of the foregoing I think we are required to construe the word "executed" in the sense of "signed" because of the following from White v. United States, 305 U. S. 281, 292:

"* * * Moreover, every deduction from gross income is allowed as a matter of legislative grace, and 'only as there is clear provision therefor can any particular deduction be allowed * * * a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.' * * *"

Here it is not at all "clear" that appellant is entitled to the deduction.

Having reached the conclusion that "executed" in the statute means "signed," it is necessary to determine whether "a written contract" includes a corporate charter. I think it does not. Properly construed, I think the statute means only those written contracts which are "signed" on behalf of the corporation. The articles of incorporation which become the charter of the corporation, are not signed by the corporation, but are signed by the incorporators. The articles are simply a step in the formation of the corporation. "The promoters of a corporation are not in any sense the agents of the corporation before it comes into existence, for there cannot be an agency unless there is a principal." 18 C. J. S. 522, Sec. 120.

The remaining contentions argued are that the act in question is unconstitutional. The historical background of the act may be found in Martin, Taxation of Undistributed Corporate Profits, 35 Mich. L. Rev. 44.

Petitioner contends that the act is an attempt to control distribution of profits, a matter reserved to the states by the Tenth Amendment of the Constitution. Amici curiae contend that the tax is one of the stockholder's share in the petitioner's accumulated profits which is not authorized by the Sixteenth Amendment; that the actual purpose of the act is to regulate economic conduct under the thin guise of raising revenue and is a penalty on conduct; and that actually the tax is one on capital which is not authorized by the Sixteenth Amendment.

I think each of these contentions confuses purpose with motive. The purpose of the act is expressed therein when it levies a tax upon "net income" to be measured by a percentage of "undistributed net income." It may be that the things or reasons which motivated the expression of the purpose by Congress were not, considered alone, within the power of Congress. However, we are not concerned with

the motives of Congress. Sonzinsky v. United States, 300 U. S. 506, 513 contains much of pertinence:

"Every tax is in some measure regulatory. To some extent it interposes an economic impediment to the activity taxed as compared with others not taxed. But a tax is not any the less a tax because it has a regulatory effect * * * and it has long been established that an Act of Congress which on its face purports to be an exercise of the taxing power is not any the less so because the tax is burdensome or tends to restrict or suppress the thing taxed * * *

"Inquiry into the hidden motives which may move Congress to exercise a power constitutionally conferred upon it is beyond the competency of courts * * * They will not undertake, by collateral inquiry as to the measure of the regulatory effect of a tax to ascribe to Congress an attempt, under the guise of taxation, to exercise another power denied by the Federal Constitution * * *"

It is enough if one purpose is within the Congressional power, notwithstanding there may have been other purposes, which, considered alone, Congress had no power to make effective. Stephenson v. Binford, 287 U. S. 251, 276; Hampton & Co. v. United States, 276 U. S. 394, 412. See also: Henneford v. Silas Mason Co., 300 U. S. 577, 586. Wholly apart from these views, I think Helvering v. Nat. Grocery Co., 304 U. S. 282, precludes us from upholding the contentions made.

Finally, both petitioner and amici curiae contend that the act unreasonably discriminates between written and oral contracts prohibiting distribution of earnings and profits, in violation of the Fifth Amendment of the Constitution. "The power of Congress in levying taxes is very wide, and where a classification is made of taxpayers that is reasonable, and not merely arbitrary and capricious, the FifthAmendment can not apply." Barclay & Co. v. Edwards, 267 U. S. 442, 450. "A legislature is not bound to tax every member of a class or none. It may make distinctions of degree having a rational basis, and when subjected to judicial scrutiny they must be presumed to rest on that basis if there is any conceivable state of facts which would support it." Carmichael v. Southern Coal Co., 301 U. S. 495, 509. The rule applies to the Federal government. Steward Machine Co. v. Davis, 301 U. S. 548, 584.

Respondent states in his brief: "It is a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether an ordinary written contract prohibits payment of dividends. But it would be an almost insuperable burden for the Bureau to determine the validity and scope of oral contracts of that nature." I think it is apparent that the difficulties which would arise regarding the proof of an oral contract, and its validity, including the effect of statutes of fraud, form a rational basis for the classification. "Administrative convenience and expense in the collection or measurement of the tax are alone a sufficient justification for the differences between the treatment of small incomes or small taxpayers and that meted out to others." Carmichael v. Southern Coal Co., supra, 511.

See also Madden v. Kentucky, — U. S. —, January, 29, 1940. Reason compels the conclusion here that likewise administrative convenience and expense are a rational basis for the classification made.

I think the decision should be affirmed.

[Endorsed:] Opinion and Dissenting Opinion. Filed Mar. 1, 1940. Paul P. O'Brien, Clerk.

Judgment

United States Circuit Court of Appeals for the Ninth Circuit

No. 9207

NORTHWEST STEEL ROLLING MILLS, INC., PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Upon Petition to Review a Decision of the United States Board of Tax Appeals

This Cause came on to be heard on the Transcript of the Record from the United States Board of Tax Appeals and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Board of Tax Appeals in this Cause be, and hereby is reversed.

[Endorsed.] Filed and entered March 1, 1940. Paul P. O'Brien, Clerk.

Certificate of Clerk, U. S. Circuit Court of Appeals for the Ninth Circuit, to Record Certified Under Rule 38 of the Revised Rules of the Supreme Court of the United States

I, Paul P. O'Brien, as Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, do hereby certify the foregoing ninety-one (91) pages, numbered from and including 1 to and including 91, to be a full, true, and correct copy of the entire record of the above-entitled case in the said Circuit Court of Appeals, made pursuant to request of counsel for the respondent, and certified under Rule 38 of the Revised Rules of the Supreme Court of the United States, as the originals thereof remain on file and appear of record in my office.

Attest my hand and the seal of the said the United States Circuit Court of Appeals for the Ninth Circuit, at the City of San Francisco, in the State of California, this 4th day of May A. D. 1940.

[SEAL] (Sgd.) PAUL P. O'BRIEN,
Paul P. O'Brien,
Clerk.

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Supreme Court of the United States

Order allowing certiorari

Filed October 14, 1940

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit is granted, and the case is assigned for argument immediately following No. 8.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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In the Supreme Court of the United States

OCTOBER TERM, 1939

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NORTHWEST STEEL ROLLING MILLS, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit, entered in the above-entitled case on March 1, 1940, reversing the decision of the Board of Tax Appeals.

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 14–18) is unreported. The opinions in the Circuit Court of Appeals (R. 77–85) are reported in 110 F. (2d) 286.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 1, 1940 (R. 85). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether, in computing its "undistributed net income" for purposes of the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936, respondent, a Washington corporation, is entitled to credit under Section 26 (c) (1) of that Act on the ground that its charter and the state law constitute a written contract executed by the corporation, expressly dealing with and prohibiting payment of dividends during the taxable year 1936.

2. Whether respondent proved that, under state law, it could not legally pay dividends during the tax year.[1]

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[1] These two questions are those decided adversely to the Government in the court below. Should the writ be granted, respondent will doubtless urge in support of the judgment below that the undistributed profits tax is unconstitutional, as here applied, because it allows a credit in the case of a written contract restricting the payment of dividends but not in the case of a similar oral contract. This contention was rejected by the court below and the decision in this respect is, we believe, plainly correct for the reasons set forth both in the majority and dissenting opinions (R. 79, 84–85).

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set out in the Appendix, *infra*, pp. 10–19.

STATEMENT

The facts, as found by the Board of Tax Appeals (R. 14–15), may be summarized as follows:

Respondent is a corporation organized in 1926 under the laws of the State of Washington. Its principal place of business is Seattle, Washington. (R. 14.)

Respondent's surplus by appraisal at the beginning and end of 1936 was $134,173.90. Its operating deficit as of December 31, 1935, was $76,983.26, and its net income for the year ended December 31, 1936, was $76,049.71. (R. 14.)

From 1926 to 1936 respondent was indebted in considerable sums to the Seattle First National Bank. This indebtedness was evidenced by ninety-day notes which were renewed from time to time. In January 1934, when respondent proposed again to renew the notes, then aggregating approximately $115,000, the officer of the bank who was handling the matter told respondent's officers that a condition of renewal would be payment of $1,000 a month in reduction of the principal amount of the indebtedness, together with payments of any available surplus remaining in respondent's treasury after satisfaction of its current operating expenses. Respondent was given to understand that in case of a breach of this condition the bank would apply

for the appointment of a receiver. This condition to renewal of the notes was not reduced to writing and no written contract was ever executed by respondent which dealt with the payment of dividends. From January 1934 to July 1936, the amount of respondent's indebtedness to the bank was reduced to $85,000 and this amount was paid on July 6, 1936. (R. 14–15.)

In computing its surtax on undistributed profits, the respondent claimed a credit of $75,085.26 for contracts restricting dividend payments. The Commissioner disallowed the credit and determined a deficiency of $13,628.22 (R. 6–12). The action of the Commissioner was sustained by the Board (R. 18–19), but the court below reversed, one judge dissenting (R. 82).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that in the computation of its "undistributed net income" for purposes of the surtax imposed by Section 14 of the Revenue Act of 1936, respondent is entitled to a credit under Section 26 (c) (1) of that Act.

(2) In failing to hold that respondent is not entitled to such a credit because its corporate charter and the laws of the state of incorporation do not constitute a written contract executed by the corporation expressly dealing with and prohibiting the payment of dividends, within the meaning of Section 26 (c) (1).

(3) In failing to hold that respondent did not prove that it was prohibited under local law from paying dividends during the taxable year 1936.

(4) In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

Under the laws of the State of Washington, a corporation is prohibited from paying dividends in cash or property except from surplus. Remington's Revised Statutes of Washington, Volume 5, Title 25, Sections 3803–24, *infra*, pp. 11–13. In the court below respondent contended that during the tax year 1936 it had no surplus within the definition of the Washington law and consequently that it could not legally have paid dividends. It urged that its charter and the laws of Washington constituted a "written contract executed by the corporation prior to May 1, 1936" expressly dealing with and prohibiting the payment of dividends, within the meaning of Section 26 (c) (1) of the Revenue Act of 1936, and that consequently it was entitled to the credit claimed. It further contended that unless a credit were allowed by reason of the prohibition against the payment of dividends imposed by Washington law, the undistributed profits tax, as applied to it, would be unconstitutional. And finally it contended that the tax was invalid because it permitted a credit in the case of a *written* contract restricting the payment of dividends and denied a credit in the case of an *oral* understanding

such as respondent's arrangement with the Seattle Bank. The Commissioner contended, on the other hand, that respondent's charter and the state law did not constitute a written contract executed by the corporation within the meaning of Section 26 (c) (1), that the Act so construed was constitutional, and that in any event respondent had failed to prove that its financial situation was such that state law prohibited it from paying dividends.

The court below, after expressing the opinion that the Act was not subject to attack because of the different treatment accorded oral and written contracts restricting the payment of dividends, held, one judge dissenting, that respondent's charter and state law constituted a written contract executed by the corporation within the meaning of Section 26 (c) (1), that the taxpayer had proved that, under state law, it could not legally have paid dividends during the tax year, and that consequently it was entitled to the credit claimed.

1. The decision of the court below that respondent's charter and the state law constituted a written contract executed by the corporation within the meaning of Section 26 (c) (1) is directly in conflict with the decision of the Circuit Court of Appeals for the Eighth Circuit in *Crane-Johnson Co.* v. *Commissioner,* 105 F. (2d) 740. The taxpayer's petition for certiorari in the *Crane-Johnson* case (No. 584, present Term) was denied on January 15, 1940 (308 U. S. 627), but on March 25, 1940, after the rendition of the decision in this case,

a petition for rehearing of the petition for certiorari in the *Crane-Johnson* case was granted, the order denying certiorari was vacated, and the petition for certiorari was granted. Every consideration compelling issuance of the writ in the *Crane-Johnson* case is equally applicable here.[2]

The desirability of having this case heard together with the *Crane-Johnson* case is emphasized by the fact that respondent's argument that the Act is unconstitutional because of the different treatment accorded oral and written contracts restricting the payment of dividends, is a contention not made by and not available to the petitioner in the *Crane-Johnson* case. It would be helpful in the administration of the revenue laws to have this question disposed of at the same time that the issues common to the two cases are decided.

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[2] The question common to the instant case and the *Crane-Johnson* case has been decided in the Government's favor in the following additional cases: *Bastion Bros.* v. *McGowan*, 32 F. Supp. 93 (W. D. N. Y.), appeal to the Circuit Court of Appeals for the Second Circuit pending; *Utah Hotel Co.* v. *Hinckley* (D. Utah), decided January 29, 1940, not yet officially reported, but may be found in 1940 C. C. H., Vol. 4, par. 9342; *Cooperative Publishing Co.* v. *Commissioner*, 40 B. T. A. 465, appeal to the Circuit Court of Appeals for the Ninth Circuit pending; *McBrides, Inc.* v. *Commissioner* (B. T. A.), unreported memorandum opinion of June 20, 1939; *American Nat. Realty Co.* v. *Commissioner* (B. T. A.), unreported memorandum opinion of January 31, 1940; *Ingersoll Amusement Co.* v. *Commissioner* (B. T. A.), unreported memorandum opinion of January 31, 1940; *Clovis Hotel Co.* v. *Commissioner* (B. T. A.), unreported memorandum opinion of February 7, 1940.

2. A further question raised in this case is whether respondent has proved that, under state law, it could not have distributed by way of dividends any of the profits upon which the surtax was sought to be imposed. Cf. *Helvering* v. *Fitch,* No. 243, present Term; *Helvering* v. *Leonard,* No. 426, present Term. The mere fact that the taxpayer had an operating deficit at the close of 1935 does not compel the conclusion that it could not have declared dividends out of its net profits for 1936 so long as it had sufficient surplus, and the record does not disclose that it did not have such a surplus. See Remington's Revised Statutes of Washington, Vol. 5, Title 25, Secs. 3803–24 (pp. 11–13, *infra*); cf. *Jorguson* v. *Apex Gold Mines Co.,* 74 Wash. 243, 244, 245; *Goodnow* v. *American Writing Paper Co.,* 73 N. J. Eq. 692; *United Light & Power Co.* v. *Grand Rapids Trust Co.,* 85 F. (2d) 331, 336 (C. C. A. 6th), certiorari granted, 299 U. S. 534, dismissed per stipulation, 299 U. S. 618; Cook, *Corporations,* 8th Ed., Vol. II, Sec. 546, pp. 1905–1908. In overruling the Government's contention that the respondent had failed to prove the non-existence of a surplus, the court below relied upon the testimony of one of respondent's officers to the effect that the company had never been in a position to pay dividends so far as he knew (R. 50). This testimony, even though not objected to at the hearing, was a mere conclusion of law which does not constitute proof of the essential facts.

CONCLUSION

The judgment below is erroneous and conflicts with the *Crane-Johnson Co.* case, *supra,* in which the taxpayer's petition for certiorari has been granted. It is therefore respectfully submitted that this petition for a writ of certiorari should be granted.

FRANCIS BIDDLE,
Solicitor General.

MAY 1940.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(*a*) *Definitions.*—As used in this title—

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(*c*) *Contracts Restricting Payment of Dividends.*

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of profits of taxable year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) *Double credit not allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

* * * * *

Remington's Revised Statutes of Washington, Vol. 5, Title 25, c. 1–A:

§ 3803–24. *Capital carried as liability—Computation—Dividends how paid.*

1. Every corporation shall carry upon its books as a liability the amount of its capital stock as defined in section 3803–1, subdivision 10.

2. Amounts of surplus arising from an unrealized appreciation or revaluation of

fixed assets shall be shown on the books of the corporation as a separate item apart from surplus profits or paid-in surplus.

3. In computing the aggregate of the assets of the corporation, the board of directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off at least annually in proportion to their use as may be determined by the board of directors.

4. No corporation shall pay dividends,

a. in cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets;

b. in shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock.

5. Cash dividends shall not be paid out of surplus due to or arising from,

a. any profit on treasury shares before resale; or

b. any unrealized profits due to increase in valuation of inventories before sale; or

c. the unaccrued portion of unrealized profits on notes, bonds, or obligations for the payment of money purchased or acquired at a discount unless such notes, bonds, or obligations are readily marketable, in which case they may be taken at their actual market value; or

d. the unaccrued or unearned portion of any unrealized profit in any form whatever,

whether in form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise.

6. Subject to the limitations contained in this section, a dividend may be declared in shares of the corporation whenever the board of directors so determine: *Provided,* That

a. if the dividend is to be paid in shares having a par value, the aggregate par value of such shares shall not exceed the amount of that portion of the corporation's surplus which is transferred to capital as payment for such shares;

b. if the dividend is paid in shares having no par value, the number of such shares may be fixed by the board of directors;

c. no dividend payable in shares of any class shall be paid to shareholders of any other class unless the articles so provide or such payment is authorized by the vote of the holders of a majority of the shares of the class in which the payment is to be made.

7. A corporation which owns wasting assets intended for sale in the ordinary course of business, such as mines, or oil or gas wells, or timber, or a corporation which owns property having a limited life, such as a lease for a term of years, or patents, need not deduct the depletion of such assets by sale or lapse of time in the computation of the fund available for dividends, and such a corporation may pay dividends from the net profits arising from its business without deduction of such depletion, subject, however, to the rights of the shareholders of different classes. [L. '33, p. 785, § 24.]

§ 3803–25. *Unlawful dividends.* If any dividend be paid in violation of section 3803–24, or if any other unlawful distri-

bution, payment or return of assets be made to shareholders,

1. The directors who knowingly, or without making reasonable inquiry, voted in favor thereof shall be jointly and severally liable to the corporation in an amount equal to the amount of the dividend so paid and the distribution, payment or return of assets so made;

2. Every shareholder who received any such dividend or any such distribution, payment or return of assets shall in the following instances be individually liable to the corporation in an amount equal to the amount so received by him:

a. when no director is liable to the corporation as provided in subdivision 1 of this section, or

b. to the extent that the corporation is unable to obtain satisfaction after judgments recovered against directors upon the liability imposed by subdivision 1 of this section.

3. No action shall be brought against a director under subdivision 1, or against a shareholder under subdivision 2

a. unless brought within two years from the date on which such payment, distribution or return was made; and no action shall be brought against a shareholder, under subdivision 2

b. unless brought within two years from the date of final judgment against the directors. [L. '33, p. 787, § 25.]

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 14–1. *Surtax on undistributed profits of corporations.*—In general, the Act imposes a surtax on the net income of corpora-

tions in an amount measured by the undistributed net income. The rates of surtax are graduated in brackets, the lowest rate being 7 percent of that portion of the undistributed net income not in excess of 10 percent of the adjusted net income and the highest rate being 27 percent of that portion of the undistributed net income which is in excess of 60 percent of the adjusted net income.

* * * * *

The undistributed net income is defined in section 14 (a) (2) as the adjusted net income minus the sum of (*a*) the dividends paid credit provided in section 27 (see articles 27 (a)–1 to 27 (h)–1, inclusive), and (*b*) the credit provided in section 26 (c), relating to contracts restricting the payment of dividends (see article 26–2).

* * * * *

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*— (*a*) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both section 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(*b*) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but cannot be distributed within the taxable year as a dividend in another form (as, for example,

in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but cannot be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26 (c) (1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April

30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

The term "debt" as used in section 26 (c) (2) does not include an obligation of the corporation to a shareholder, as such, as distinguished from a creditor. Accordingly, amounts paid into, or set aside for, a sinking fund by a corporation for the retirement of preferred stock, pursuant to the terms of an agreement underlying the pre-

ferred stock issue, shall not be considered as set aside for discharge of a debt. An indebtedness evidenced by bonds or other similar obligations issued by a corporation is incurred as of the date such obligations are issued, and the amount of such indebtedness is the amount represented by the face value of the obligations. For the purpose of this article a bond or other similar obligation is not issued until it is executed and delivered to a person who holds it as a debt of the corporation. Bonds issued after April 30, 1936, in exchange in refunding a preexisting issue represent debts incurred after April 30, 1936, within the meaning of section 26 (c) (2).

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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 121

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NORTHWEST STEEL ROLLING MILLS, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 14–18) is unreported. The opinions in the Circuit Court of Appeals (R. 77–85) are reported in 110 F. (2d) 286.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 1, 1940 (R. 85). The petition for a writ of certiorari was filed on June 1, 1940, and granted on October 14, 1940. The jurisdiction of this Court rests on Section 240 (a) of the Judi-

cial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether, in computing its "undistributed net income" for purposes of the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936, respondent, a Washington corporation, is entitled to credit under Section 26 (c) (1) of that Act on the ground that its charter and the state law constitute a written contract executed by the corporation, expressly dealing with and prohibiting the payment of dividends during the taxable year 1936.

2. Whether the undistributed profits tax, as applied to respondent, is unconstitutional.

3. Whether respondent has shown that it was prohibited by state law from paying out all or a part of its net income for 1936 as dividends.

STATUTES AND REGULATIONS INVOLVED

The federal statutes and Treasury regulations involved are set out in the appendix to the Government's brief in *Crane-Johnson Company* v. *Helvering,* No. 8, present Term, with which the present case is to be argued. The applicable Washington statutes are set out in the appendix to this brief, *infra,* pp. 17–20.

STATEMENT

The facts, as found by the Board of Tax Appeals (R. 14–15), may be summarized as follows:

Respondent is a corporation organized in 1926 under the laws of the State of Washington. Its principal place of business is Seattle, Washington (R. 14).

Respondent's surplus by appraisal at the beginning and end of 1936 was $134,173.90. Its operating deficit as of December 31, 1935, was $76,983.26, and its net income for the year ended December 31, 1936, was $76,049.71 (R. 14).

From 1926 to 1936 respondent was indebted in considerable sums to the Seattle First National Bank. This indebtedness was evidenced by ninety-day notes which were renewed from time to time. In January 1934, when respondent proposed again to renew the notes, then aggregating approximately $115,000, the officer of the bank who was handling the matter told respondent's officers that a condition of renewal would be payment of $1,000 a month in reduction of the principal amount of the indebtedness, together with payments of any available surplus remaining in respondent's treasury after satisfaction of its current operating expenses. Respondent was given to understand that in case of a breach of this condition the bank would apply for the appointment of a receiver. This condition to renewal of the notes was not reduced to writing and no written contract was ever executed by respondent which dealt with the payment of dividends. From January 1934 to July 1936, the amount of respondent's indebtedness to the bank

was reduced to $85,000 and this amount was paid on July 6, 1936. (R. 14–15.)

In computing its surtax on undistributed profits, the respondent claimed a credit of $75,085.26 as an amount which could not be distributed because of contracts restricting dividend payments. The Commissioner disallowed the credit and determined a deficiency of $13,628.22 (R. 6–12). The action of the Commissioner was sustained by the Board (R. 18–19), but the court below reversed, one judge dissenting (R. 82).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that in the computation of its "undistributed net income" for purposes of the surtax imposed by Section 14 of the Revenue Act of 1936, respondent is entitled to a credit under Section 26 (c) (1) of that Act.

(2) In failing to hold that respondent is not entitled to such a credit because its corporate charter and the laws of the state of incorporation do not constitute a written contract executed by the corporation expressly dealing with and prohibiting the payment of dividends, within the meaning of Section 26 (c) (1).

(3) In failing to hold that respondent did not prove that it was prohibited under local law from paying dividends during the taxable year 1936.

(4) In reversing the decision of the Board of Tax Appeals.

ARGUMENT

Under the laws of the State of Washington, a corporation is prohibited from paying dividends in cash or property except from surplus. Remington's Revised Statutes of Washington, Volume 5, Title 25, Section 3803–24, *infra*, pp. 17–19. In the court below respondent contended that during the tax year 1936 it had no surplus within the definition of the Washington law and consequently that it could not legally have paid dividends. It urged that its charter and the laws of Washington constituted a "written contract executed by the corporation prior to May 1, 1936" expressly dealing with and prohibiting the payment of dividends, within the meaning of Section 26 (c) (1) of the Revenue Act of 1936, and that consequently it was entitled to the credit claimed. It further contended that unless a credit were allowed by reason of the prohibition against the payment of dividends imposed by Washington law, the undistributed profits tax, as applied to it, would be unconstitutional. And finally it contended that the tax was invalid because it permitted a credit in the case of a *written* contract restricting the payment of dividends and denied a credit in the case of an *oral* understanding such as respondent's arrangement with the Seattle Bank. The Commissioner contended, on the other hand, that respondent's charter and the state law did not constitute a written contract executed by the corporation within the meaning of

Section 26 (c) (1), that the Act so construed was constitutional, and that in any event respondent had failed to prove that its financial situation was such that state law prohibited it from paying dividends.

The court below, after expressing the opinion that the Act was not subject to attack because of the different treatment accorded oral and written contracts restricting the payment of dividends, held, one judge dissenting, that respondent's charter and state law constituted a written contract executed by the corporation within the meaning of Section 26 (c) (1), that the taxpayer had proved that, under state law, it could not legally have paid dividends during the tax year, and that consequently it was entitled to the credit claimed.

I

The decision of the court below that respondent's charter and the state law constituted a written contract executed by the corporation within the meaning of Section 26 (c) (1) is, we believe, clearly erroneous for the reasons set forth at length in Point I of the Government's brief in *Crane-Johnson Company* v. *Helvering,* No. 8, present Term, with which the present case is to be argued. Reference is made to the Government's brief in the *Crane-Johnson* case for the arguments in support of the Government's position here.

The only difference between the present case and the *Crane-Johnson* case on this issue is that

the Washington statute applicable here prohibits the corporation itself, as well as its directors, from distributing dividends except from surplus, whereas the prohibition of the North Dakota statute involved in the *Crane-Johnson* case is addressed only to the directors. Since, however, the principal contentions made by the Government in the *Crane-Johnson* case are not dependent upon the particular form of the North Dakota statute, this difference is without significance for present purposes.

II

In the court below, respondent advanced various arguments against the constitutionality of the undistributed profits tax, as applied to it, which are not available to petitioner in the *Crane-Johnson* case.

1. In the first place, it contended that the tax is invalid because it permits a credit in the case of a written contract restricting the payment of dividends and denies a credit in the case of an oral contract, such as respondent's arrangement with the Seattle Bank. In our view, this contention is not available to respondent. Respondent's indebtedness to the bank was fully discharged on July 6, 1936 (R. 15); the company could at any time thereafter have distributed its 1936 earnings by way of dividends without any possible violation of its understanding with the bank. It is plain, therefore, that even had Congress granted a credit to

corporations under oral contractual restraints against the payment of dividends, respondent would not have been entitled to the credit. In these circumstances, respondent cannot be heard to urge that the absence of such a credit renders the tax invalid. Cf. *Clark* v. *Kansas City*, 176 U. S. 114, 118.

But in any event, as the court below held,[1] Congress was amply justified in according different treatment to restraints against the payment of dividends imposed by written contracts and restraints imposed by oral contracts. Deductions or credits are a matter of legislative grace within the sound discretion of Congress and respondent is in no position to complain simply because the grace was extended to others and not to it. See Government's brief in the *Crane-Johnson* case, p. 44. Moreover, there was clearly a rational basis for the distinction drawn by Congress between oral and written contracts. It is a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether an ordinary written contract prohibits the payment of dividends. But the existence and scope of oral contracts are not susceptible of ready proof, and it would impose a tremendous burden upon the Bureau if it were required to determine, every time a credit was claimed,

[1] The court below appears to have assumed *arguendo* (R. 79) the existence of an oral contract with the bank under which respondent was to apply its earnings to the payment of its indebtedness.

whether the alleged oral contract was really made, what its precise terms were, and whether it was valid under state law. Furthermore, the grant of a credit in the case of oral contracts would have presented an obvious method for tax evasion by unscrupulous taxpayers. These considerations plainly warrant the different treatment which Congress, in the exercise of its discretion, accorded to oral and written agreements. *Carmichael* v. *Southern Coal Co.*, 301 U. S. 495; *Steward Machine Co.* v. *Davis*, 301 U.S.548; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *Woolford Realty Co.* v. *Rose*, 286 U. S. 319; see also the other authorities cited in the Government's brief in the *Crane-Johnson* case at pp. 46–47.

2. The other constitutional arguments advanced by respondent in the court below were that the undistributed profits tax constitutes an illegal federal interference with state power to control the distribution of corporate earnings in violation of the Tenth Amendment and that it is invalid because it is a "penalty tax."

It is apparent from the discussion in the Government's brief in the *Crane-Johnson* case (pp. 40–41) that the undistributed profits tax was enacted as a revenue measure. It was designed to prevent the avoidance of surtax by stockholders and to equalize the tax burden on all business profits, whether distributed or not, and whether realized by corporations or by unincorporated en-

terprises. The nature of the legislation as a revenue measure is not affected by the fact that the surtax was, in part, intended to induce corporations to distribute earnings which they might otherwise have accumulated, since the act so induced would result directly in increased taxes. Nor can the surtax be deemed to be a penalty rather than a revenue measure when imposed on corporations with undistributed earnings which, because of state law or otherwise, cannot be distributed. The imposition of the surtax on such corporations has as its direct result an increase in the amount of the tax payable; furthermore, it serves to equalize the tax burden imposed on the income of such corporations and on the income of corporations which distribute their profits. That these revenue purposes, rather than a purpose to penalize corporations which refuse to violate state law, motivated enactment of the statute scarcely needs argument.

Helvering v. *National Grocery Co.*, 304 U. S. 282, is persuasive authority against respondent's position. The Court there sustained, over precisely the same objections as are raised here, the constitutionality of Section 104 of the Revenue Act of 1928, which imposed a surtax on corporations formed or availed of to prevent the imposition of surtaxes upon their shareholders. The Court stated (pp. 286–289):

> 1. It is said that the statute violates the Tenth Amendment because it interferes with

the power to declare or to withhold dividends—a power which the State conferred upon the corporation. The statute in no way limits the powers of the corporation. It merely lays the tax upon corporations which use their powers to prevent imposition upon their stockholders of the federal surtaxes. "Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose." *United Business Corp.* v. *Commissioner,* 62 F. (2d) 754, 756.

* * * * *

2. It is said that the statute is unconstitutional because the liability imposed is not a tax upon income, but a penalty designed to force corporations to distribute earnings in order to create a basis for taxation against the stockholders. If the business had been carried on by Kohl individually all the year's profits would have been taxable to him. If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxable to the partners individually, although these had been retained by the partnership undistributed. See *Heiner* v. *Mellon, ante,* p. 271. Kohl, the sole owner of the business, could not by conducting it as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits. If it preferred, Congress could lay the tax upon the corporation, as was done by § 104. The penal nature of the imposition

> does not prevent its being valid, as the tax was otherwise permissible under the Constitution. Compare *Helvering* v. *Mitchell*, 303 U. S. 391.

See also *United Business Corporation* v. *Commissioner*, 62 F. (2d) 754 (C. C. A. 2d); *Almours Securities, Inc.* v. *Commissioner*, 91 F. (2d) 427, 429 (C. C. A. 5th), certiorari denied, 302 U. S. 765, rehearing denied, 303 U. S. 666.

Respondent also suggested in the court below that "the tax is not on income at all, but is dependent upon what the taxpayer does with its income already taxed." (Reply Brief, p. 20.) To this contention, too, the *National Grocery* case is a complete answer. The tax is specifically imposed on income and it is not the less an income tax because a credit is given to the extent that the income, by being distributed, becomes taxable to the stockholders.[2] If the income is not distributed, the corporation pays the tax; if it is distributed, the stockholders pay the tax. In either event, the subject of the tax is the income itself.

III

There is also a serious question here, as in the *Crane-Johnson* case, whether respondent has

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[2] It is clear that Congress can impose a tax on the net income of a corporation even though the corporation has a deficit. See *Long Beach Improvement Co.* v. *Commissioner*, 5 B. T. A. 590, cited with apparent approval by this Court in *Willcuts* v. *Milton Dairy Co.*, 275 U. S. 215, 220. See also *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359.

proved that it could not legally have paid dividends during the tax year 1936.

The applicable state statute (Remington's Revised Statutes of Washington, Vol. 5, Title 25, Section 3803–24, *infra,* pp. 17–19) prohibits a corporation from paying dividends "except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets". Section 3803–25 (*infra,* p. 19) imposes liabilities upon directors and stockholders declaring or receiving dividends paid in violation of law.

The record in this case shows, and the Board found, that respondent's surplus by appraisal at the beginning and end of 1936, the taxable year, was $134,173.90, that its operating deficit as of December 31, 1935, was $76,983.26, and that its net income for 1936 was $76,049.71 (R. 14). No certified financial statements of respondent are in evidence.

In our view, these findings do not justify the conclusion that respondent was prohibited by Washington law from paying out as dividends in 1936 its net profits of some $76,000. ' The mere fact that the taxpayer had an operating deficit at the close of 1935 would not have prevented it from declaring dividends out of its profits during the taxable year so long as it had sufficient surplus and

the record does not show that it did not have such a surplus. The record does show "surplus by appraisal" of some $134,000 and that would have been more than sufficient to cover dividends of $76,000 unless the surplus was created by "unrealized appreciation in value or revaluation of fixed assets" and the record does not show that it was.

The court below was of opinion that the requisite proof was supplied by the following testimony of respondent's vice president and general manager (R. 50):

> Q. Had the company ever been in a position to pay the bank in full prior to that time? [July 6, 1936.]
>
> A. No, sir.
>
> Q. Had it ever been in a position to pay dividends?
>
> A. Not that I know of.

In the first place, this testimony, whatever its probative value, appears to relate only to the period prior to July 6, 1936, when the indebtedness to the bank was discharged; under the oral agreement with the bank, no dividends could have been paid by the company prior to that time. There is no testimony at all that during the remaining six months of the tax year respondent could not have paid out all of its 1936 net earnings as dividends.

In the second place, this testimony, even though not objected to at the hearing, was a mere conclusion of law which does not constitute proof of the essential facts. See, e. g., *Walker* v. *McLoud*, 204

U. S. 302, 310; *Parker Co.* v. *Commissioner*, 49 F. (2d) 254, 256 (C. C. A. 5th); *Pruett* v. *Midkiff*, 273 Ill. App. 142, 145–146; *Norfolk & W. Ry. Co.* v. *McCoy*, 257 Ky. 32, 34. This is particularly true since the testimony involved the legal effect of the Washington statute, on which question the opinion of the witness was neither controlling nor material.

Respondent cites various state court decisions [3] to the effect that, in certain circumstances, improper evidence, if admitted without objection, must be treated as legal evidence. Assuming this to be the true rule, it does not avail respondent. We may concede that, in the absence of objection, the testimony here involved must be accepted as evidence of the witness' opinion concerning the capacity of the company to pay dividends, but it does not follow from this that the witness' opinion is of any probative force in establishing the facts concerning which the opinion was ventured.

It is plain that the burden of proof was upon respondent to show that it could not have paid dividends during the tax year without violating the state law. *New Colonial Co.* v. *Helvering*, 292 U. S. 435; *Welch* v. *Helvering*, 290 U. S. 111; *Helvering* v. *Fitch*, 309 U. S. 149. Petitioner having failed to furnish the requisite proof, neither the

[3] *Schanbacher* v. *Lucido Bros. Grocery Co.*, 93 S. W. (2d) 1076 (St. Louis Ct. of App.); *Sanley* v. *Wilkinson*, 107 Okla. 54, 229 Pac. 574; *Spicer* v. *Henderson*, 43 S. W. 27 (Tex. Civ. App.); *Sugerman* v. *Stelling*, 135 N. Y. Supp. 595.

Commissioner nor the courts are called upon to conjecture as to what the actual situation in 1936 may have been.

CONCLUSION

The decision of the court below should be reversed on the ground that the Washington statute prohibiting the payment of dividends except from surplus is not a provision of a written contract executed by the respondent within the meaning of Section 26 (c) (1) and that the undistributed profits tax, so construed, is constitutional. But if the Court should hold otherwise, the decision of the court below should be reversed on the ground that respondent has not sustained the burden of proving that the distribution of its net income for 1936 would have constituted a violation of state law.

Respectfully submitted.

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RICHARD H. DEMUTH,
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APPENDIX

Remington's Revised Statutes of Washington, Vol. 5, Title 25, c. 1-A:

§ 3803-24. CAPITAL CARRIED AS LIABILITY—COMPUTATION—DIVIDENDS HOW PAID.

1. Every corporation shall carry upon its books as a liability the amount of its capital stock as defined in section 3803-1, subdivision 10.

2. Amounts of surplus arising from an unrealized appreciation or revaluation of fixed assets shall be shown on the books of the corporation as a separate item apart from surplus profits or paid-in surplus.

3. In computing the aggregate of the assets of the corporation, the board of directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off at least annually in proportion to their use as may be determined by the board of directors.

4. No corporation shall pay dividends,

a. in cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets;

b. in shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities,

including in the latter the amount of its capital stock.

5. Cash dividends shall not be paid out of surplus due to or arising from,

a. any profit on treasury shares before resale; or

b. any unrealized profits due to increase in valuation of inventories before sale; or

c. the unaccrued portion of unrealized profits on notes, bonds, or obligations for the payment of money purchased or acquired at a discount unless such notes, bonds, or obligations are readily marketable, in which case they may be taken at their actual market value; or

d. the unaccrued or unearned portion of any unrealized profit in any form whatever, whether in form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise.

6. Subject to the limitations contained in this section, a dividend may be declared in shares of the corporation whenever the board of directors so determine: *Provided,* That

a. if the dividend is to be paid in shares having a par value, the aggregate par value of such shares shall not exceed the amount of that portion of the corporation's surplus which is transferred to capital as payment for such shares;

b. if the dividend is paid in shares having no par value, the number of such shares may be fixed by the board of directors;

c. no dividend payable in shares of any class shall be paid to shareholders of any other class unless the articles so provide or such payment is authorized by the vote of the holders of a majority of the shares of the class in which the payment is to be made.

7. A corporation which owns wasting assets intended for sale in the ordinary course of business, such as mines, or oil or gas wells, or timber, or a corporation which owns property having a limited life, such as a lease for a term of years, or patents, need not deduct the depletion of such assets by sale or lapse of time in the computation of the fund available for dividends, and such a corporation may pay dividends from the net profits arising from its business without deduction of such depletion, subject, however, to the rights of the shareholders of different classes. [L. '33, p. 785, § 24.]

§ 3803–25. UNLAWFUL DIVIDENDS. If any dividend be paid in violation of section 3803–24, or if any other unlawful distribution, payment or return of assets be made to shareholders,

1. The directors who knowingly, or without making reasonable inquiry, voted in favor thereof shall be jointly and severally liable to the corporation in an amount equal to the amount of the dividend so paid and the distribution, payment or return of assets so made;

2. Every shareholder who received any such dividend or any such distribution, payment or return of assets shall in the following instances be individually liable to the corporation in an amount equal to the amount so received by him:

a. when no director is liable to the corporation as provided in subdivision 1 of this section, or

b. to the extent that the corporation is unable to obtain satisfaction after judgments recovered against directors upon the liability imposed by subdivision 1 of this section.

3. No action shall be brought against a director under subdivision 1, or against a shareholder under subdivision 2

a. unless brought within two years from the date on which such payment, distribution or return was made; and no action shall be brought against a shareholder, under subdivision 2

b. unless brought within two years from the date of final judgment against the directors. [L. '33, p. 787, § 25.]

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In the Supreme Court of the United States

OCTOBER TERM 1939

NO. [redacted] 121

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner,

vs.

NORTHWEST STEEL ROLLING MILLS, INC.,

Respondent.

RESPONSE TO PETITION FOR WRIT OF CERTIORARI

MOTION FOR ADVANCEMENT OF CAUSE FOR ORAL ARGUMENT TO BE HEARD CONTEMPORANEOUSLY WITH ARGUMENT ON CAUSE NO. 584

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In the Supreme Court of the United States

OCTOBER TERM 1939

NO. 1063

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner,

vs.

NORTHWEST STEEL ROLLING MILLS, INC.,

Respondent.

RESPONSE TO PETITION FOR WRIT OF CERTIORARI

In response to the petition for writ of certiorari, Northwest Steel Rolling Mills, Inc. admits those statements contained in the petition under the caption "Opinions Below," and "Jurisdiction," and, before referring to other portions of the petition, makes the following motion:

MOTION FOR ADVANCEMENT OF CAUSE ON THE CALENDAR AND FOR ARGUMENT OF CRANE-JOHNSON AND NORTHWEST STEEL ROLLING MILLS CASES CONTEMPORANEOUSLY.

Pursuant to Rule 20 (Subdivisions 3 and 8), respondent through its counsel respectfully moves this Honorable Court for an order advancing the above entitled cause, No. 1063, on the calendar for argu-

ment so that such cause may be argued contemporaneously with Cause No. 584 (*Crane-Johnson Co. v. Commissioner of Internal Revenue*).

Respondent's counsel are authorized to state that the Solicitor General joins in the above request.

The grounds for this request are that the same sections of the Revenue Act of 1936 are involved in both cases (Sections 14 and 26, Revenue Act of 1936) and the taxpayer in each case contends that by virtue of the charter of a corporation, such corporation is entitled to a credit under Section 26 in determining undistributed profits tax, it being the contention that the charter of the corporation is a written contract within the meaning of Section 26 (c) (1). The *Crane-Johnson* petition for writ of certiorari had been denied prior to decision by the Circuit Court of Appeals, Ninth Circuit, of the *Northwest Steel Rolling Mills* case. After a decision by the Ninth Circuit in the *Northwest Steel Rolling Mills* case, the petition in the *Crane-Johnson* case was granted by this Court.

Constitutional questions are presented in the *Northwest Steel Rolling Mills* case of importance to taxpayers and the Commissioner of Internal Revenue, and an advancement of this cause to be heard with the *Crane-Johnson* case would permit a decision of these questions, if necessary for the Court to decide the questions, contemporaneously with a disposition of the *Crane-Johnson* case. We quote from the petition for review in this cause to demonstrate the importance which the Commissioner attaches to such decision as a guide:

> "The desirability of having this case heard together with the *Crane-Johnson* case is emphasized by the fact that respondent's argument

that because of the different treatment accorded oral and written contracts restricting the payment of dividends, is a contention not made by and not available to the petitioner in the *Crane-Johnson* case. It would be helpful *in the administration of the Revenue Laws,* to have this question disposed of at the same time that the issues common to the two cases are decided." (*Petition,* p. 7). (Italics ours.)

In each of the cases (1063 and 584) the taxpayer corporation, while realizing income for the tax year in question, claims that because of state laws, distribution of a dividend during the tax year could not be made and therefore Section 26 (c) (1) applied because the corporate charter is a contract embodying state laws and a dividend could not be distributed "without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with payment of dividends."

Thus the same issue of interpretation of the language of Section 26 (c) (1) arises although a different result might be obtained in the two cases by reason of the fact that the North Dakota statute involved in the *Crane-Johnson* case prohibited *directors* from distributing dividends, whereas the Washington statute applicable in the *Northwest Steel Rolling Mills* case prohibited the *corporation itself* from distributing dividends.

QUESTIONS PRESENTED

In further response to the petition for writ of certiorari, the following questions were presented to the Circuit Court of Appeals in the *Northwest Steel Rolling Mills* case:

1. Is a corporate charter from the State of Washington, which charter was granted prior to May 1, 1936, and embodies the general corporation law of the State of Washington, a written contract within the meaning of Section 26 of the Revenue Act of 1936, entitling petitioner to the credits allowed under that section?

2. Are Sections 14 and 26 arbitrary and discriminatory and an illegal interference by the federal government with state sovereignty if construed as disallowing a credit although petitioner's charter prohibits payment of dividends?

3. Are Sections 14 and 26 of the Revenue Act of 1936 arbitrary and discriminatory in that they deny credit to petitioner because of the provision of an *oral* contract with a credit or bank prohibiting the payment of dividends whereas they allow credit where similar provisions are contained in a *written* contract?

STATEMENT

Respondent was incorporated under the laws of the State of Washington in the year 1926 (R. 14). Respondent had an operating deficit as of December 31, 1935, of $76,983.26, and its net income for the year 1936 did not equal the amount of such deficit (R. 14).

From 1926 to 1936, respondent had been indebted to the Seattle-First National Bank. The bank in 1934 required payments of $1,000 per month in reduction of the principal of the indebtedness of approximately $115,000, and exacted the condition that if there was a failure by respondent to make these payments, the bank would apply for the appointment of a receiver. This condition was oral. In July, 1936, respondent paid the balance of $85,000 due the bank (R. 14, 15).

Respondent had never been in a position to pay dividends (R. 50).

Respondent claimed, and the Commissioner disallowed, a credit under Section 26, Revenue Act of 1936, for contracts restricting dividend payments, and the Commissioner determined that there was a deficiency of $13,628.22 (R. 6, 12). This action of the Commissioner was sustained by the Board (R. 18, 19), but reversed by the Circuit Court of Appeals for the Ninth Circuit (R. 82).

The Uniform Business Corporation Act, Laws of 1933, p. 785, Section 24, of the State of Washington; Remington Revised Statutes 3803-24 (2, 3, 4, and 5) provides that:

> "No *corporation* shall pay dividends"

unless the conditions therein prescribed are met.

The statute of North Dakota construed in the *Crane-Johnson Co. v. Commr. of Internal Revenue* case, Section 4543 of the North Dakota Compiled Laws of 1913, provides that:

> "The *directors* of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must *they* divide, withdraw, or pay to the stockholders, or any of them, any part of the capital stock, nor must *they* create debts beyond the subscribed capital stock. * * * " (Italics ours.)

In the foregoing respect the statutes of the state, constituting a part of the charters of the corporations, are different in that the Washington statute prohibits the *corporation* from paying dividends, whereas the North Dakota statute prohibits the *directors* of the corporation from paying dividends.

CONCLUSION

It is respectfully submitted that the motion for advancement of this cause on the calendar so that oral argument in this cause will be heard contemporaneously with oral argument in *Crane-Johnson v. Commissioner of Internal Revenue* should be granted.

Respectfully submitted,

D. G. EGGERMAN,

WALSER S. GREATHOUSE,

Counsel for Northwest Steel Rolling Mills, Inc.

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In the Supreme Court of the United States

OCTOBER TERM, 1940.

No. 121.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER.

v.

NORTHWEST STEEL ROLLING MILLS, INC.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF FOR APPELLEE, NORTHWEST STEEL ROLLING MILLS, INC.

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In the Supreme Court of the United States

OCTOBER TERM, 1940.

No. 121.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER.

v.

NORTHWEST STEEL ROLLING MILLS, INC.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF FOR APPELLEE, NORTHWEST STEEL ROLLING MILLS, INC.

OPINIONS BELOW.

Board of Tax Appeals—(R. 16-18); (unreported); *Circuit Court of Appeals*—(R. 77-85); 110 Fed. (2d) 286.

JURISDICTION.

As this is written the petition for writ of certiorari has not been granted. If the petition is granted, jurisdiction will rest on Sec. 240 (a), *Judicial Code,* as amended by Act of February 13, 1925.

STATEMENT.

Appellant claimed that under §14, Revenue Act of 1936 (Appendix), surtax on *undistributed profits* should be imposed on Appellee for the year 1936, and determined a deficiency of $13,628.22. Appellee denied that *any* such tax was proper, asserting a credit based on §26 (c) (1) (Appendix) to the extent of the undistributed profits because of contracts restricting payment of dividends.

The Board of Tax Appeals denied the credit upon the authority of the Board's previous decision in the *Crane-Johnson* case. The Board's decision was reversed by the Circuit Court of Appeals (9) which allowed the credit and held that Appellee's charter is a contract within the meaning of §26 (c) (1), and that Appellee had proved it is entitled to the credit and was restrained by its Charter from distributing a dividend in 1936.

Appellee was incorporated in Washington State in 1926, and its place of business was and is in Seattle (R. 14). Its articles of incorporation provide in part:

> "That the purposes and objects for which this corporation are formed are: * * *
>
> "Nineteenth. To exercise such powers as are or may be granted or conferred by the general incorporation laws of the State of Washington. * * * " (R. 58, 63; Exh. 3).

Pertinent State laws binding on Appellee with respect to dividends are set forth in the Appendix.

These laws prohibit dividends unless *actual* surplus of assets over liabilities exists. While Appellee had a surplus by *appraisal,* there is no evidence that there was an *actual* surplus at any time.

Mr. Goetz, who had been general manager of Appellee continuously from January 2, 1934, testified that there was never a time within his knowledge when appellee was in a position to pay a dividend (R. 50). *This testimony is uncontroverted.* Appellee had a deficit continuously from 1926, when it was incorporated, until 1936 (R. 50). This deficit had been steadily accumulating (R. 50). As of the close of 1935, the deficit was $76,983.26 (R. 14, 71). Net income for 1936 was $76,049.71 (R. 14), or less than the deficit existing at the end of the preceding year, leaving a deficit at the end of 1936.

In 1926, Appellee had borrowed $150,000 from a Seattle bank (R. 38, 15). In 1935 it owed, on ninety day note, $115,000, at which time the bank required payment of $1,000 a month (R. 38, 39, 49, 15). The bank had been criticized by the Bank Examiner because of the amount of the indebtedness (R. 39, 15), and the executive committee of the bank was seriously concerned about the loan (R. 39, 15). Verbally the bank and Appellee agreed that all funds above operating costs would be used to reduce the loan (R. 41, 46, 47) and payment of a dividend was prohibited (R. 41). Appellee was in danger of receivership if it violated the bank's instructions (R. 41). The note was paid July 6, 1936, balance then being $85,000 (R. 49, 15), the payment being made from reduction of inventories (R. 50).

SUMMARY OF ARGUMENT.

A. Appellee should be allowed credit for contracts restricting distribution of dividends under Section 26 (c) (1), Rev. Act of 1936, because

1. Appellee was prohibited by the laws of the State of Washington from distributing a dividend in 1936 due to an existing deficit.
2. Laws of the State of Washington so prohibiting the distribution of dividends are a part of Appellee's charter.
3. The charter is a "written contract,"
4. "Executed by the corporation prior to May 1, 1936."
5. Appellee's charter expressly deals with distribution of dividends.
6. Interpretation of Section 26 (c) (1) to allow the credit conforms with rules of construction.
   (a) Any other construction would result in discrimination against "deficit" corporations prohibited by charter from distributing dividends.
   (b) A constructon is to be avoided which will raise doubt as to the constitutionality of the Act.
   (c) Doubts must be resolved in favor of taxpayer.
   (d) Relief provisions are to be liberally construed.
   (e) Administrative construction to the effect that a charter does not constitute a written contract within the meaning of the Act has not received Congres-

sional approval by re-enactment of the statute, is contrary to judicial precedent, unreasonable and invalid.

(f) Administrative construction in other respects supports Appellee's position.

7. Legislative history is consistent with Appellee's position.
8. Stock certificate is a contract within Section 26 (c) (1).

B. If the Act is construed to disallow the credit, when applied to Appellee it is unconstitutional as:

1. Arbitrary and discriminatory in violation of the Fifth Amendment to the Federal Constitution;
2. An invasion by the Federal Government of the powers delegated to the states to regulate corporations, in contravention of the Tenth Amendment;
3. Outside the power to tax authorized by the Sixteenth Amendment, and the tax is not apportioned.

A.

In order for the credit to be available there must be a written contract. This contract so long as it is in writing, need be of no particular type or classification. It may be private or public. Under the well established judicial rule that a corporate charter is a contract, and in the absence of specific exclusion of charters by the Act, the word "contract" embraces a corporate charter. Likewise, it embraces the stock certificate.

State incorporation laws are held by concert of judicial opinion to be *part* of the charter. So emphatic is this rule that if there is conflict between the incorporation laws and other language of the articles of incorporation the laws prevail. The incorporation laws are by *express reference* in the articles *and* by operation of law, made a part of the charter of Appellee. Such laws are held to be *provisions* of the charter as much as if written in the articles verbatim.

The state incorporation laws prohibited Appellee from paying a dividend in 1936 because of Appellee's deficit, and also prohibited the trustees from paying a dividend. A dividend if paid would have been illegal. These laws being part of the charter constituted a basic part of the contract between Appellee, the State and the stockholders. The laws *expressly* prohibit the *corporation* from paying a dividend while a deficit exists. That Appellee could not have paid a dividend is uncontroverted in the evidence. Thus under basic conditions and provisions of the charter, Appellee was expressly prohibited from paying a dividend.

The words "executed by the corporation prior to May 1, 1936," refer to *time* rather than *manner*. This portion of the statute is designed to limit the time beyond which contracts, though effective and binding, will be available to taxpayer for the credit. The intent is that if prior to May 1, 1936, a written contract binding on the corporation is in effect, this portion of the statute has been complied with. Appellee's charter was effective in 1926.

If "executed" refers to *manner* of entering into

the contract, the word is broader in meaning than "to sign." To execute a contract requires a meeting of minds and a completion of all things necessary to make the contract binding. Acceptance may be through an agent. Under the law of Washington State there is practically identity between incorporators and corporations. Also under Washington law ratification of the incorporators' acts by the corporation is a recognized principle. The charter was fully executed by Appellee in 1926 under either a time or manner interpretation of the statutory language.

The interpretation of the Circuit Court (9th) is consistent with rules of construction. Doubts should be resolved in favor of taxpayer. 26 (c) (1) is a relief provision and should be construed liberally. The construction contended for by Appellant would lead to an unjust result in that deficit corporations in 12 states could distribute dividends and obtain credit, while those in 36 states can not distribute without violating state laws. An act should not be construed to obtain a flagrantly absurd result. The purpose of the law should be kept in mind. It was to require distribution of *surplus*. Where no surplus exists, the reason for the requirement ceases.

Legislative history, while of littie help generally due to difference in the bills before House and Senate, indicates that the word "executed" had no technical import but meant "entered into" or "in existence."

Practical considerations weigh heavily in Appellee's favor. Under Appellant's contention, Appellee would have to pay the Federal Government in excess

of $13,000 because the State Government prohibits it from distributing a dividend as a matter of public policy. Placing the tax on undistributed net income was designed to persuade or compel distribution to shareholders. Such persuasion or compulsion runs squarely against State law in Appellee's case. The bureau is conclusively presumed to know the provisions of the charter. It is constantly in touch with corporation affairs and could as easily determine the facts under a public contract (the Charter) as under a private contract.

Congress admittedly, in 1938, recognized the injustice of the results of this law *as administered under the Treasury Regulations* and provided appropriate remedy. The Treasury Regulation is not binding upon the Courts and is contrary to well settled judicial precedent.

B.

If construed as not including a credit to Appellee, the Act is unconstitutional because it arbitrarily discriminates between a charter and other written contracts; between oral and written contracts; between deficit corporations able to pay a dividend and those not able to do so because of state law; and between deficit corporations and other corporations because it is doubtful, at least, whether a distribution by a deficit corporation to a stockholder would result in a taxable dividend in the hands of the stockholder, and if it did not then the corporation could not obtain a dividend paid credit under the Act, whereas other corporations distributing surplus could obtain such dividend paid credit.

Further, if so construed, the Act induces and is

intended to induce distributions despite state regulations. The states have exclusive regulatory power over corporations. Dividends are an important matter to stockholders and creditors. Their restriction is public policy. The inducement in the Act here considered is not necessary as an incident to taxation.

Also, the tax as to deficit corporations can not be on income but is on capital until impairment of capital has been restored. The tax is not apportioned. It does not come within the Sixteenth Amendment.

ARGUMENT.

I.

Appellee Was Prohibited by the Laws of the State of Washington From Declaring or Distributing a Dividend in the Tax Year of 1936 Because of an Existing Deficit.

A. *State Laws.*

Section 1, Article XII of the Constitution of the State of Washington provides:

> "Corporations may be formed under general laws, but shall not be created by special acts. All laws relating to corporations may be altered, amended, or repealed by the legislature at any time, *and all corporations doing business in this state may, as to such business, be regulated, limited or restrained by law.*" (Italics supplied.)

Appellee was organized as a corporation under the laws of the State of Washington in 1926 (R. 14, Exh. 3, Art. of Inc.; R. 58-66, Exh. 4; R. 67).

Article II, Section 19 of the Articles of Incorporation expressly refers to the incorporation laws (R. 63).

The laws of the State of Washington prohibit a *corporation* from paying dividends unless there is a surplus of the aggregate of assets over the aggregate of liabilities, including in the latter the amount of the corporation's capital stock, and that surplus must be *real* and *actual* and not simply a book entry. *Uniform Business Corporation Act,* Laws of 1933, p. 785, §24, State of Washington; *Rem. Rev. Stat.* 3803-24 (3, 4, 5), quoted in Appendix.

The State statute further gives *to the corporation* a right of action against the directors and the shareholders in the event of a violation of the section above quoted (*Appendix, Rem. Rev. Stat.* 3803-25).

It is *unlawful* for the trustees of a corporation to

> "Make any dividend except from the net profits arising from the business of the corporation"

and it is *unlawful* to divide, withdraw or in any way pay to the stockholders, or any of them, any part of the capital stock of the company. *Rem. Rev. Stat.* 3823, Laws of 1923, p. 543, §2 (Appendix). See *State ex rel. Washington etc. Co. v. Murray,* 181 Wash. 27, 37, 38; 42 Pac. (2d) 429 (1935).

The rule in the State of Washington, adopted long prior to 1926 and followed uniformly, is that capital stock is a trust fund for payment of corporate debts and must not be impaired by distributions to stockholders, and solvency of the corporation is immaterial. *Brenneman v. Whitehouse,* 85 Wash. 355, 358, 359; 148 Pac. 24 (1915).

> "While the company is solvent, the dividend receiving stockholder can be compelled to return the dividends received by him, if paid out of capital, irrespective of whether or not those dividends are necessary to satisfy the company's liabilities." *Gaunce v. Schoder,* 145 Wash. 604, 610; 261 Pac. 393.

Dividends paid in impairment of capital of the corporation are "illegal." *Sparling v. Gen. Discount & Mtge. Corp.,* 178 Wash. 663, 670, 35 Pac. (2d) 60; affirmed on rehearing 184 Wash. 387, 50 Pac. (2d) 1023.

In the *Sparling* case, the Court cited with approval *Jorguson v. Apex Gold Mine Co.,* 74 Wash. 243, 133 Pac. 465, 46 L. R. A. n. s. 637, in which the rule was enforced to the extent that:

> "Any contract whereby a corporation seeks to diminish its capital stock, except in some way permissible by statute, *contravenes public policy* and is unenforcible."

Also cited was *Austin v. Wright,* 156 Wash. 24, 27, 286 Pac. 48, in which the opinion points out that the uniform rule applicable to corporations incorporated in the State of Washington is that the corporation:

> "Could only pay dividends out of profits"

and in the *Jorguson* case, *supra,* the Court stated:

> " 'The rule of law that requires corporations to preserve their capital intact is alone sufficient to prevent the corporation from paying dividends except out of profits.' 5. *Thompson, Corporations,* 2nd ed., §5305."

There are no "profits" which can be divided so long as there is a deficit. *Willcuts, Collr. v. Milton*

Dairy Co., 275 U. S. 215, 218, 72 Law Ed. 247, 248.

> "The rule is that a corporation does not have earnings or profits available for distribution as dividends until impairments of capital or paid in surplus resulting from operating losses have been restored. *Willcuts v. Milton Dairy Co.*, 275 U. S. 215; *Crystal Ice Co.*, 14 BTA 682; *Arthur C. Stipel*, 29 BTA 1145; *Louise Glassell Shorb*, 22 BTA 644; *Loren D. Sale*, 35 BTA 938. This rule is recognied by the Commissioner. G.C.M. 1552, C. B. VI—1, p. 10." *Kinnear v. Commr.*, 36 BTA 153, 155. *Foley Securities Co. v. Commr.*, 106 Fed. (2d) 731, 732, 733.

B. *Evidence of Deficit.*

Mr. Goetz, general manager of Appellee, testified that Appellee had *never* been in a position to make a dividend (R. 50). Appellee had sustained a deficit since its incorporation (R. 50). Appellee's precarious financial situation was a matter of concern to the lending bank and to the Bank Examiners (R. 15, 39). Any cash above operating expense had to be devoted to the bank loan which was paid off during 1936 by reduction of inventories (R. 15, 41, 46, 47, 49, 50). As Mr. Goetz phrased it, a deficit had been "accumulating right along" (R. 50). That Appellee could not pay a dividend is undisputed in the evidence.

Appellant argues that the testimony of inability to distribute dividends is limited to the period prior to the payment of the bank loan. But the word "ever" is used in the question relating to the inability of Appellee to pay a dividend. Appellant's contention requires the reading by implication into the question and answer the words "before July 6,

1936." It is plain that such meaning was not intended. Such meaning is inconsistent with the use of the word "ever." Further, the subjects are not necessarily related. The question limited in time related to the bank loan. The question unlimited in time referred to dividends.

Appellant contends that Goetz's testimony is a conclusion of law and as such is of no effect. This contention was first advanced by Appellant in the Circuit Court of Appeals. No objection was made before the Board. In arguments to the Board the issue was accepted as being whether the charter is a contract within §26 (c) and whether the Act was constitutional. The argument comes rather late on the evidentiary feature. The contention lacks merit.

> "In approaching the questions presented for our decision, we have in mind the elementary rule that issuable facts need not be shown by direct evidence, but may be arrived at by fair inference. We have in mind also the rule that parties have a right to try their case on evidence which is not of the quality and character required by the law, and where such evidence is admitted without objection, it is the right and duty of the court to give it the same consideration as if it were legal evidence." *Schanbacher, et al. v. Lucido Bros.*, 93 S. W. (2d) (Mo.) 1076, 1081.
>
> "Agency of this case is a question of law to be determined by the court upon the primary facts, and such facts only should have been elicited from the witness upon this point, and the answer of the witness states a legal conclusion and was incompetent. *Ford Motor Co.*

v. Levesay, 61 Okla. 231, 161 Pac. 901. This evidence was admitted however without objection and stands without any effort of the plaintiff to strike it from the records. When incompetent evidence is thus admitted it must be given its natural effect. This evidence therefore is sufficient to make a prima facie proof of agency * * * ." *Stanley v. Wilkinson,* 229 Pac. (Okla.) 574, 576.

The following cases also support the proposition that even assuming a witness testifies to a conclusion, if such testimony is admitted without objecton, it is of probative value. *Spicer, et al v. Henderson,* 43 S. W. (Texas) 27; *Sugerman, et al. v. Stelling, et al.,* 135 N. Y. Supp. 595; *Ridenhour v. Okla. Contracting Co.,* 45 S. W. (2d-Mo.) 108, 112; *Maine v. May Stern Furniture Co.,* 21 S. W. (2d-Mo.) 211, 213; *Wood v. Consolidated School Dist. No. 13,* 7 S. W. (2d-Mo.) 1018, 1021.

> "Parties have a right to try their case on evidence which is not of the quality or character required by law, and where such evidence is admitted without objection, it is the right and duty of the court or jury to give it the same consideration as if it were legal evidence." 23 C. J. 39, §1783, 'Evidence.' "

Consequently, assuming, which we do not concede, that the testimony of Mr. Goetz is only a conclusion, still it went in without objection and no attack was made upon it in the record. It was uncontroverted.

Had the Board refused to accept the testimony referred to, and which was uncontroverted, such refusal would have been error.

> "Since no evidence whatever was submitted for respondent, it was error wholly to ignore this testimony." *Belridge Oil Co. v. Commr.*, (CCA-9) 85 Fed. (2d) 762, 768.

Cases cited in support of the argument that the testimony is ineffective though admitted without objections are inapplicable. In *Walker v. McCloud*, 204 U. S. 302, 310, the testimony was that an Indian Chieftain had *ratified* a sheriff's sale, but the proof showed that the sale was conducted in violation of law and the witness testifying regarding the ratification stated that prior to the sale the Chief told him "to proceed according to law to dispose of the buildings * * *." This Court stated that it "would hardly be supposed that the Chief would at once ratify a violation of the law in the conduct of the sale." Thus, the witness' own testimony refuted ratification.

In *Parker Co. v. Commr.*, 49 F. (2d) 254, the charter of a corporation was not introduced in evidence. A witness stated that the corporation belonged to a certain legal classification. This was the statement of an opinion on a point of law. The Court, not having the charter before it, could not pass upon the question.

In *Pruett v. Midkiff*, 273 Ill. App. 142, the witness showed no familiarity with the financial condition of the corporation but testified that the corporation was insolvent..

In *Norfolk & W. Ry. Co. v. McCoy*, 257 Ky. 32, opinion evidence as to damage was unsupported by any facts. The Court remarked that "an earnest review of the testimony" of plaintiff's witnesses showed that the verdict "is flagrantly against the evidence."

In the instant case, Goetz was the manager and knew the company's condition. He testified to an accumulating deficit. Facts were proven as to the bank loan and the seriousness with which the bank and the Bank Examiner regarded the situation. That Appellee had never been in a position to pay a dividend is a statement of fact coming from the manager of the company. It would be so regarded if made to a stockholder. There is nothing in the record to refute it.

Appellant argues that the Goetz testimony is opinion evidence.

> "No rule applicable to all cases can be laid down as to what constitutes an opinion or conclusion as distinguished from a statement of fact. In determining the admissibility of evidence, it is more important to get the truth than to quibble over impractical distinctions between facts and conclusions." *Nichols,* "Applied Evidence," Vol. IV, p. 3399.

The "quibble" made in the Appellate Court comes after the evidence is in and there is less reason for its consideration than there would be if it had come in the form of an objection during the trial. In any event, the Goetz testmony did not go to a matter of interpretation of State law. The witness was presumed to know the statutory law. That law is unequivocal. The testimony relates to a factual situation, namely, inability to pay a dividend because of the financial position of the corporaton.

The Circuit Court's opinion on this phase of the case is amply sustained by the evidence. The minority opinion does not take issue with the majority's

conclusion that there was proof of the deficit and that dividends could not have been paid legally.

Determination of facts by the Court below which facts are not without substantial support in the evidence are accepted as unassailable. *Alabama Power Co. v. Ickes,* 302 U. S. 464, 476; *Paige v. Ark. Natural Gas Corp.,* 286 U. S. 269, 271; *In matter of Tax Service Assn. of Ill.,* 305 U. S. 160, 163; *Tex. & New Orleans R. R. Co. v. Brotherhood,* 281 U. S. 548, 558.

Appellant refers to surplus by *appraisal,* but concedes that the test under the law of the State of Washington is *actual* surplus. (See *Rem. Rev. Stat.,* 3803-24 (3).) This being so, whether surplus by appraisal existed is immaterial.

Appellant cites *Goodnow v .American Writing Paper Co.,* 73 N. J. Eq. 692, 69 Atl. 1014, and contends that a dividend may be declared out of profits even though the total assets of the company may not exceed its debts and the nominal share capital. This certainly is not the law in the State of Washington. However, under the New Jersey Act considered in that case, it was provided that the directors of a corporation shall not make dividends, except from surplus, *or from net profits* arising from the business of such corporation." The Court stated:

> "Although the change in language indicates that the Legislature made a distinction between surplus and net profits, it does not necessarily follow that *net profits* mean the difference between gross earnings and what may be called operating expenses. Such profits may be called annual profits, *and it may be that by net profits the Legislature meant the net profits upon the*

whole of the company's business from its organization."

The same term "net profits" is used in *Rem. Rev. Stat.* 3823 (Appendix) prohibiting trustees from making distribution "except from the net profits arising from the business of the corporation." If the reasoning of the *Goodnow* case is applied, there could be no distribution because there were no "net profits," for Appellee had operated at a loss upon the whole of the company's business from its organization.

II.

LAWS OF THE STATE OF WASHINGTON PROHIBITING THE DISTRIBUTION OF A DIVIDEND ARE A PART OF THE CHARTER.

A. *Express Reference.*

The Articles of Incorporation expressly refer to the incorporation laws.

> "Article II. That the purposes and objects for which this corporation is formed are * * *
>
> "Nineteenth: To exercise such powers as are or may be granted or conferred by the general incorporation laws of the State of Washington. * * * " (R. 58, 63; Exh. 3).

By this reference the laws become a part of the Charter *as much as if written therein. Interstate Consol. St. R. Co. v. Massachusetts,* 207 U. S. 79, 84, 85; 52 Law Ed. 111, 114.

B. *Part of Charter by Operation of Law.*

The Charter embraces the Articles of Incorporation, the statutes and general incorporation laws of the state of incorporation.

"Thus, while strictly speaking there is no

charter where a corporation is created under a general law, the incorporation papers, whether called articles of incorporation, application for incorporation, certificate of incorporation, or any other term, together with the signature, seal or decree of approval, are often referred to as the charter, although, as a matter of law, the so-called charter consists of such papers and the statutes under which the corporation is created. *In other words, the provisions of the statute or general incorporation laws enter into and form a part of the charter.* This is the meaning applied in construing the corporate charter, in doing which the corporation papers and statute are to be construed together, *the latter controlling in case of a conflict,* and in this respect a charter under general law is the equivalent of one by special act.

"It is not necessary that the *general law* should be copied in the charter, *but it forms an essential part of it,* and all parties are bound by its terms, whether copied in the charter or found only on the statute books. Moreover, constitutional provisions automatically become a part of the charter." *Fletcher, Cyclopedia Corporations,* Perm. ed. Vol. 1, Sec. 164, pp 541, 542. (Italics Supplied.)

The charter and by-laws of a corporation constitute a contract between the company and its stockholders *into which the statutes of the state of its incorporation enter and are controlling.*

Ainsworth v. Southwest Drug Corp. (C.C.A. 5,) 95 Fed. (2d) 172. 173.

"The relationship existing between a corporation and its stockholders is one of contract. (*Shattuck & Desmond Warehouse Co. v. Gillelen* 154 Cal. 778, 99 P. 348), in which the charter and by-laws of the corporation *and pertinent statutes of the state are embodied.* (*Jones v. Northwest Edison Electric Co.* (C.C.A.), 144 Fed.765, 770.)"

Schroeter v. Bartlett Syndicate Bldg. Corporation, (Cal.) 55 Pac. (2d) 1221.

"Where corporations are organized under the general law, * * * * the *charter* of a private corporation *consists not only of the articles of incorporation, but includes all general statutes applicable to that class of corporation,* and *all persons, whether stockholders or creditors, who have dealings with the corporation are conclusively presumed to do so with knowledge of its charter and of its* charter rights * * * * "

Loveland & Co. v. Doernbecher Mfg. Co. (Ore.) 39 Pac. (2d) 668, 673. (Italics supplied.)

"Where possible, we must endeavor to give effect to all *provisions* of the *statute* and *certificates* which are sufficiently clear and definite as to be reasonably understood and expressive of the agreement between the incorporator and between the corporation and its stockholders. *Such provisions are a constitutent part of the contract entered into."*

Yoakam v. *Providence Biltmore Hotel Co., et al.,* (D. C. R. I.) 34 Fed. (2d) 533, 541. (Italics supplied.)

> "It is the rule that, in construing a corporate charter, the incorporation papers and statutes of the state of incorporation are to be construed together. *The statutes need not be copied into the charter, but they form an essential part of it,* and all parties are bound thereby, whether contained in the charter or only in the statutes. Statutory or constitutional provisions *automatically* become a part of the charter. Fletcher on Corporations, Vol. 1., Sec. 164."
>
> *Ontjes v. Bagley,* 217 Iowa 1200, 250 N. W. 17, 19. (Italics ours.)

Appellant does not take issue with the well settled principle that incorporation laws of the state are a part of the Charter. Appellant could hardly take issue with that fact in this case because those laws are expressly referred to in the Articles of Incorporation. Secondly, Appellant does not take issue with the legal principle that a charter is a contract. Appellant's argument may be fairly summarized from the following quotations from his brief:

> "Certainly in normal parlance, those words ('a provision of a written contract executed by the corporation') neither connote nor comprehend the provisions of a state regulatory statute."
>
> "A corporate charter is not a contract 'executed' by the corporation."

The first statement will be answered here, the second under the head *infra* "Executed."

The issue is one of Congressional intent. The test to apply to words for determining that intent is set

forth in the cases cited by Appellant of *Lynch v. Allworth-Stephens Co.*, 267 U. S. 364, 370; *Old Colony R. Co. v. Commr.*, 284 U. S. 552, 560; and *Levy's, Lessee, v. McCartee*, 6 Pet. 102, 110. We quote from these cases.

> "The Legislature must be presumed to use words in their known and ordinary signification unless that sense be repelled by the context." *Levy's, Lessee, v. McCartee, supra.*
>
> And the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover." *Lynch v. Allsworth-Stephens Co., supra.*

In the latter case, provision was made for deduction from gross income to include a reasonable allowance for the "exhaustion * * * of property." This Court stated:

> "There is nothing to suggest that the word 'property' is used in any restricted sense."

It was held that the word was not to be given a restricted meaning.

In *Old Colony R. Co. v. Commr., supra,* it is stated:

> " 'The popular or received import of words furnishes the general rule for the interpretation of public laws. * * * " (p. 560)
>
> "We can not believe that Congress used the word (interest) having in mind any concept other than the usual, ordinary and every day meaning of the term, or that it was acquainted

with the accountant's phrase 'effective rate' of interest and intended that as the measure of the permitted deduction. * * * " (p. 561.)

"If there were doubt as to the connotation of the term, and another meaning might be adopted, the fact of its use in a tax statute would incline the scale to the construction most favorable to the tax payer." (Citing cases) (p. 490.)

Appellant tries to distinguish between contract and statute. The fallacy in this argument is that the statute is both expressly and by operation of law a *part of the contract.* It is not something unrelated to the contract. It *is* the contract and if there is conflict between the *words* in the articles and the laws made a part of the articles, the laws prevail. *Oregon R. R. & Navigation Co. v. Oregonian Ry. Co.,* 130 U. S. 1, 21, 24, 25; *Ex parte Norfolk Ry. & Light Co.,* 142 Va. 323, 128 S. E. 602, 603, 604. Corporations have a very different status in some respects than individuals and the status of a corporation with the state and with its stockholders requires the embodiment of statutory provisions in the corporation's very charter because of that unusual relation.

Appellant's argument attempts to distinguish between a voluntary obligation and a statutory restraint. Again, the distinction is inaccurate. The incorporation laws become a part of the contract and their terms are *voluntarily* accepted by the corporation and acted upon.

Thus the Circuit Court opinion is correct in drawing the conclusion that the incorporation laws are

a part of the contract and "Aside from that, the taxpayer's Articles of Incorporation 'expressly' refer to the general incorporation laws of the State of Washington. * * * " (R. 80.)

Appellant contends that the provision must be *expressly* written in the contract. The statute does not so state. The words are:

> "Provision of a written contract * * * which provision *expressly deals* with the payment of dividends."

The provision may be either written in or incorporated by reference or made a part of the contract by operation of law. In either case the provision is a part of the contract.

III.

CHARTER OF APPELLEE IS A "WRITTEN CONTRACT."

A. *"Written."*

The Articles of Incorporation are in writing. Likewise the laws of the state are written.

B. *"Contract."*

That the charter of a corporation is a *contract* has been so long established that it seems superfluous to argue the matter. *Trustees of Dartmouth College v. Woodward,* 4 Wheat. (U.S.) 518, 627, 4 Law Ed. 629.

> "The charter of a private corporation constitutes a contract, not only between the state and the corporation, the shareholders and the corporation but also between the state and the shareholders. This is settled law. *Wilmington RR. v. Reid,* 13 Wall 264, 20 Law Ed. 568; *Larabee v. Dolley* (D.C.) 175 Fed. 365, 390; *Garey v. Mining Co.,* 32 Utah 497, 91 Pac. 369,

12 L.R.A. (n. s.) 554; *Cook* on *Corporations* (3rd ed.) 492 to 496, incl. The transaction necessarily involves the assent of the shareholders." *Tyler v. Dane County* (D.C.- Wis.) 289 Fed. 843, 855, 856.

To the same effect: *Home Bldg. & Loan Assoc. v. Blaisdell,* 290 U. S. 398, 429, 430; *Gorman v. A. B. Leach & Co., Inc.,* (C.C.-N.Y.) 11 Fed. (2d) 454, 456; *Sanderson v. Salmon River Canal Co.,* 45 Idaho 234, 263 Pac. 32. *Personal Industrial Bank v. Citizens Budget Co.,* 80 Fed. (2d) 327, 328 (CCA-6); Cert. den. 298 U. S. 674.

As this Court stated in *Chango Bridge Co. v. Binghampton Bridge Co.,* 70 U. S. 51, at 73, the principle that an act of incorporation is a contract is so well settled that the Courts are:

> "Estopped from questioning the doctrine," and:
>
> "The security of property rests upon it, and every successful enterprise is undertaken, in the unshaken belief that it will never be forsaken. * * * An attempt even to reaffirm it, could only tend to lessen its force and obligation."

IV.

"Executed by the Corporation Prior to May 1, 1936."

Black's "Law Dictionary" (3d ed.), p. 716 defines "executed" as follows:

> "Completed; carried into full effect; already done or performed; taking effect immediately; now in existence or in possession; conveying an immediate right or possession. The opposite of executory."

Bouvier's "Law Dictionary," Vol. I, p. 1111, (Rawle's Revision) defines the word "executed" as follows:

> "Done; completed; effectuated; performed; fully disclosed; vested; giving perfect right of employment."

In Washington Finance Corp. v. Glass, 74 Wash. 653, 661, 134 Pac. 480, 483, the Court stated:

> "A note is executed when it is complete in its parts and *launched on the current of trade.* The note sued on, although signed by certain parties and in this sense executed by them was not an executed instrument within the meaning of the law. It was not ready for delivery nor was it delivered until the name of the payee was inserted and the endorsement made.
>
> " 'Execution of a note requires both a signature and delivery. In a legal sense the word 'execute' includes delivery and *implies a complete contract.' Words and Phrases,* Title 'Execute.'" (Italics supplied.)

Thus if delivery is essential and if the word "execute" implies a completed contract, there must be a contract *in being* before the "execution" can be said to have taken place. When the contract of incorporation comes into being, however, it comes into being because of the state *and* the *corporation.*

In *Gerlach, et al v. Spokane,* 68 Wash. 589, 591, 592, 124 Pac. 121, 122, the Court held that the word "execute" had a broader meaning than "to sign."

In *Fenby v. Hunt,* 53 Wash. 127, 101 Pac. 492, 493, 494, the question arose whether a chattel mortgage had been filed within time, the statute re-

quiring that in order for the mortgage to be valid as to third persons it must be filed within ten days from "date of execution." The Court held that execution requires acts necessary

> "To give the instrument validity *as between the parties.*"

and that there must be delivery and acceptance and a *meeting of the minds.*

The Senate Finance Committee, in referring to this statute, referred to contracts:

> "*Entered into* prior to March 3, 1936."

(Finance Committee Report No. 2156, 74th Congress, 2d Session, p. 12.)

The Ways and Means Committee of the House referred to

> "Written contract *in existence* prior to March 3, 1946,"

(Ways and Means Committee Report 2475, 74th Congress, 2d Session, p. 8). This, we submit, was the real meaning which Congress had in mind. The purpose of fixing a date was obviously to prevent corporations from entering into contracts to evade the law. Any contract "entered into" or "in existence" prior to that fixed time, so long as it conformed to the other requirements, was obviously intended to be within the scope of the Act. It is significant that the word "executed" is nowhere referred to in Congressional discussions as having a technical meaning. It is further significant that neither in the Board of Tax Appeals nor before the Ninth Circuit Court did the Commissioner argue that the word "executed" must be confined to a strictly technical, narrow and restricted meaning.

> "Are charters contracts 'executed by' the corporation? Congress seems to have given little special thought to its use of the word 'executed.' The Ways and Means Committees refers to a 'written contract' in existence prior to March 3, 1936 (this date being extended to May 1, 1936.) Later the Senate Finance Committee refers to contract 'entered into prior to March 3, 1936 (date extended as above stated). If the word 'executed' is to be given the meaning attributed to that word by previous decisions of the Court, it should probably be held to require only such acts as are necessary to bind the corporation by the written contract in question. Precise formality should be unimportant if there is a binding obligation. A broad meaning should be given to the word 'execute' which properly ignores technicalities." *Paul & Mertens, "Law of Federal Taxation,"* 1939 Cum. Supp., 32 A. 43 at p. 1458.

Employing the synonyms for the word "executed" in accordance with the above definitions and Court decisions, the *quaere* is whether the Charter of Northwest Steel Rolling Mills, Inc. was:

> "Entered into, in existence, completed, effectuated, performed, vested, carried into full effect, launched on the current of trade as a complete contract."

prior to May 1, 1936. The Charter was not unilateral. The offer was extended by the state permitting incorporation under certain conditions. That offer required an acceptance. That acceptance required an acceptor. The acceptor could be none other than

the corporation itself. The very act of incorporation imports a binding obligation and that binding obligation is one assumed by the corporation directly and positively, imposing upon the *corporation* duties to the state, to the stockholders and to creditors.

Appellant argues that the word "executed," "when used with reference to a written *instrument,*" means "signed, sealed and delivered." It will be observed however that the statute does not use the word "instrument." It states "written *contract.*" The common and ordinary meaning which was intended by Congress in the use of the word "executed" was that meaning which the Ways and Means Committee of the House and the Senate Finance Committee used in connection with the word and which the Treasury Department itself applied to the word namely, "entered into" or "in existence," prior to a certain date. Was there a binding obligation in writing prior to May 1, 1936, is the real question. The stress was not intended to be upon the act of making the contract. The stress was laid upon the time when the contract went into effect.

Appellant lays stress upon signing, but 'executed' is a much broader term than 'signing,' as the definitions above quoted indicate. In short, Appellant attempts to apply a restricted and technical meaning to the word, although stating as a premise of the construction that the popular and ordinary meaning should be accepted.

Appellant cites *Bouvier's "Law Dictionary,"* (Rawle's 3rd Rev.), Vol. I, p. 1111, to sustain the contention that "executed" means "signed," or "signed, sealed and delivered." Bouvier states:

> "To execute a deed, which means to make a deed, including especially signing, sealing and delivery."

It will be seen that this refers to a written *instrument* and that "execute" or "make," even as to a written instrument is a broader term than "signing, sealing and delivery." The broader meaning of "completing" etc. quoted *supra* is imported by the word "make." A deed may be signed and delivered by an agent having power of attorney. That does not prevent the deed from being "made" although the grantor does not himself sign or deliver the deed. Here, the incorporators were agents of the company, if ratification is accepted as the correct principle.

A corporation is bound by preorganization contracts of its incorporators, if these contracts are approved subsequent to incorporation, and this binding effect results from ratification. *Walnut, Park Lumber & Coal v. Roane, et al,* 17 Pac. (2d) 896, 898, 171 Wash. 362, 368 (1933). Certainly, the Charter has been approved and acted on.

> "The acceptance of a charter by the corporation arises from merely acting under it." *Ashby v. Standard Pipe & Supply Co.* (Tex. Civ. App.) 56 S. W. (2d) 218, 222.
>
> "A certificate of incorporation evidences a contract between the state *and the corporate entity created thereby." State ex rel. Sutherland v. U .S. Realty Imp. Co.,* 15 Del. C. H. 108, 132 Atl. 138.

The acceptance of a charter binds the corporation to performance of all conditions upon which it is

granted. *Ashley v. Ryan,* 153 U. S. 436, 441, 443, 38 Law Ed. 773, 776, 777. *Fed. Crude Oil Co. v. Yount-Lee Oil Co.,* 122 Texas 21, 52 S.W. (2d) 56, 60; *Badger Dome Oil Co. v. Hallam,* 99 Fed. (2d) 293, 297.

The opinion of Story, J., in *Trustees of Dartmouth College v. Woodward,* 4 Wheat. 518 at 691, 692, 693 is a clear exposition of the execution of a charter.

> "I am unable to distinguish between the case of a grant of land or of franchises to an existing corporation, and a like grant to a corporation brought into life for the very purpose of receiving the grant. As soon as it is in esse, and the franchises and property become vested and executed in it, the grant is just as much an *executed contract* as if its prior existence had been established for a century." (Italics supplied).

This is particularly true in the State of Washington where there is practically identity between incorporators and corporation.

> "When the certificate shall have been filed, the persons who shall have signed and acknowledged the same, and their successors, shall be a body corporate and politic in fact and in name, * * * ." *Rem. Rev. Stat.* 3809; Cd. '81 Sect. 2424; 1 H. C., Sect. 1500.

Appellant argues that "executed" would be superfluous under the construction given by the 9th Circuit. This argument overlooks the fact that "executed" is used, not in relation to *how* the written contract must be made, but rather *when* it must be

made. Had it not been for the fixing of a date beyond which a contract, although binding upon the corporation, would not be within the credit, the pertinent portion of the statute would undoubtedly have read:

> "Provision of a written contract expressly dealing with the payment of dividends."

It would have been unnecessary to have used the word "executed" except for the fact that Congress wished *to fix a limiting date.* The sense in which the phrase "executed by a corporation prior to May 1, 1936," is used, obviously is in relation to time and not in relation to manner. Congress had no concern with whether the contract was made by an agent, typed, printed or written in long hand so long as it was a binding, written contract, and so long as that contract was completed and in force prior to May 1, 1936. If the *manner* of making the contract had been important to Congress, undoubtedly Congress would have made some explicit provision to that effect. The words "executed by a corporation" are no more superfluous therefore than the words "entered into" or "in existence" prior to May 1, 1936, would have been. It would have been inept to say:

> "Provision of a written contract prior to May 1, 1936, which provision * * *."

Appellant confuses an act with a fact—it is the *fact* that a written contract is in being before May 1, 1936, not the *act* by which that contract came into being, to which the words "executed by the corporation prior to May 1, 1936" apply.

V.

Appellee's Charter Expressly Deals With Distribution of Dividends

The articles of incorporation *expressly* recognize that the powers of the corporation are those conferred by law. The law *expressly* restricts the corporation with respect to payment of dividends. The law is a part of the Charter both by express reference in the Articles and by accepted legal principles, *as much as if written in the Articles. Ontjes v. Bagley,* 250 N.W. (Ia.) 17, 19; *Ainsworth v. Southwest Drug Corp.* (C.C.A.-5) 95 Fed. (2d) 172, 173; *Yoakam v. Providence Biltmore Hotel Co., et al* (D.C.-R.I.) 34 Fed. (2d) 533, 541; *Fletcher, "Cyc. Corporations,"* (Perm. Ed.) Vol. I, §164, pp. 541, 542.

As stated in the opinion of the Ninth Circuit in this case,

> "The mere fact that the statute prohibits the payment of dividends during *any* year in which there is a deficit, certainly cannot militate against the idea that the statute 'expressly' deals with the disposition of profits during the year in question. See *G. B. R. Oil Corporation v. Commissioner,* 40 B.T.A. 737." See also *Joel Co. v. Commissioner,* 41 B.T.A. 829.

In *Michigan Silica Company v. Commissioner* decided Mar. 5, 1940, 41 B.T.A. No. 77 a trust indenture required the corporation to pay to a trustee 25c for each ton of sand produced and sold. Dealing with section 26 (C) (2), the Board observed:

> "It is true that this provision of the trust indenture does not 'expressly' use the term 'earnings and profits.' The statute however does

not require that such terms be used in the written contract, but only that the written contract contain a provision which 'expressly deals with the distribution of earnings and profits of the taxable year.' Applying that test, we submit that Article 3 of the trust indenture does expressly deal with the disposition of earnings and profits of the taxable year."

VI.

Interpretation of Section 26 (C) (I) to Allow the Credit Conforms With Rules of Construction.

A. *Any other Construction Would Discriminate Against Deficit Corporations Prohibited by Charter from Distributing Dividends.*

The dividend paid credit, Section 27, Revenue Act of 1936 arises where (a) "Dividends" are paid, or (b) Where part of a distribution in liquidation of the company is properly chargeable to the earnings or profits *accumulated* after February 28, 1913.

The word "dividends" as used in Section 27 is defined in Section 115 as follows:

> "(a) Definition of dividends — The term 'dividends' when used in this title means any distribution made by a corporation to its shareholders, whether in money, or in property, (1) Out of its earnings or profits accumulated after February 28, 1913 or (2) Out of the earnings or profits of the taxable year (computed as of the close of the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

Section 115 (a) (2) *supra* was an addition made

in the 1936 Act and constitutes a very substantial extension of the definition of the term "dividends." Under this definition, if earnings or profits were sufficient during the taxable year, a corporation irrespective of its deficit could have a distribution to stockholders considered as a "dividend" within the meaning of this act, and could thereby obtain a dividend paid credit even though in effect such corporation would be distributing capital.

While there is a deficit there can be no "undivided profits." *Willcuts, Collector, v. Milton Dairy Co.*, 275 U. S. 215, 218; 72 L. Ed. 247, 248.

> "The rule is that a corporation does not have earnings or profits available for distribution as dividends until impairments of capital or paid-in surplus resulting from operating losses have been restored." *Roy J. Kinnear v. Commissioner*, 36 BTA 153, 155.

Accordingly, Congress has explicitly extended the meaning of the word "dividend" for the purposes of this act in order to allow deficit corporations the benefit of a dividend paid credit. This demonstrates no purpose on the part of Congress to discriminate against deficit corporations generally but under the Commissioner's interpretation the Congress must have intended to discriminate against deficit corporations which by reason of their Charter could not, while having a deficit distribute dividends. Such intent on the part of Congress should not be implied lightly, especially in view of the extended definition which Congress deliberately gave to the term "dividends" with respect to dividend paid credits. Congress knew and is charged with knowledge that in

thirty-six states such prohibitions existed against deficit corporations.

The absurd result of the Commissioner's interpretation is that Congress must have intended to favor corporations in the twelve states allowing deficit corporations to distribute dividends, and to discriminate against the corporations in thirty-six states which did not allow the distribution.

> "However, to construe statutes so as to avoid results glaringly absurd, has long been a judicial function." *Armstrong Paint & V. Works v. Nu-Enamel Corp.*, 305 U. S. 315, 333.

Appellant argues that the law was intended to act uniformly throughout the states and that some states do not restrict dividend payments by deficit corporations. Inasmuch as most states restrict dividend payments, Appellant's argument seems to work in reverse. Uniformity can only be attained within the wording and *purpose* of the Act by giving the defiicit corporation which can not distribute dividends the credit under 26 (c) (1) because of a contract (the Charter) restricting the payment of dividends. By construing the Act in that manner, the dividend paid credit may be available to the deficit corporation that can distribute and the contract credit will be available to the deficit corporation that can not distribute.

B. *A Construction Is to Be Avoided Which Will Raise Doubt as to Constitutionality of the Act.*

The majority opinion of the Circuit Court indicates doubt of the constitutionality of this act unless construed as permitting the credit, and in other sections of this brief the constitutionality of the act will be attacked.

"A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is constitutional, *but also grave doubts upon that score,* * * * " *Linder v. U. S.* 268 U. S. 5, 17, 69 Law Ed. 819, 823; *U. S. v. Jim Fuey Moy,* 241 U. S. 394, 401, 60 Law Ed. 1061, 1064.

C. *Doubts Are Resolved in Favor of Taxpayer.*

If doubt exists as to the construction of a taxing statute, the doubt should be resolved in favor of the taxpayer.

Hasett v. Welsh, 303 U. S. 303, 314, 82 Law Ed. 858, 867.

D. *Relief Provisions Are to Be Liberally Construed.*

The Senate Committee on Finance in its report (Sen. Rep. No. 2156, 74th Congress, 2d Session, p. 15) stated:

"Contracts not to pay dividends: This credit is in principle similar to a *relief* provision allowed in the House Bill for the purpose of the undistributed profits tax imposed by that bill."

The House Report No. 2475, 74th Congress, 2d Session, p. 9, stated:

"A corporation however, can not use more than one of the *relief* provisions which is cited but must use the one that will result in the smallest tax."

Relief provisions in tax acts are to be liberally construed to afford the relief intended. *Bonwit Teller & Co. v. U. S.,* 283 U. S. 258, 263, 75 Law Ed. 1018, 1021.

Appellant argues that this credit falls within the rule as to deductions. Such is contrary to the mani-

fest intent of Congress, stated *supra*. Further, this is not a deduction from income, but relief where distribution of income could not be made.

E. *Administrative Construction to the Effect that a Charter Does Not Constitute a Written Contract Has Not Received Congressional Approval By Re-enactment of the Statute.*

Treasury Department Regulations 94, Art. 26-2, placed a construction upon this Act to the effect that a Charter was not a contract within the meaning of the Act. This construction has not received Congressional approval by re-enactment of the statute in the Revenue Act of 1938.

A regulation, in order to be valid, must be reasonable and in harmony with the statute. *Manhattan General Equipment Co. v. Commr.* (1936), 297 U. S. 129, 134; 80 Law Ed. 528, 531.

This construction by the Treasury Department was entirely new and contrary to all judicial precedent. It is argued that great weight should be attached to the departmental regulation. But there has been no long continued use of the regulation. See: *Iselin v. U. S.* (1926), 270 U. S. 245, 251; 70 Law Ed. 566, 570.

The Court is not bound by an administrative construction. *Burnett v. Chicago Portrait Co.,* (1932) 285 U. S. 1, 16-21.

Inasmuch as Congress was aware that "the laws of 36 states prohibit corporations chartered by them from making a dividend distribution if their capital is impaired" (Congressional Record, Vol. 80, Pt. 8, p. 9058), it can hardly be assumed that the lawyers on the conference committee were unaware of the

long and well established legal principle that the charters of these corporations were contracts and in the absence of legislation indicating the contrary, it is submitted that the Treasury regulation *supra* is without foundation.

F. *Administrative Construction in Other Respects Supports Appellee's Position.*

I. T. 3130, C.B. 1937-2 page 107, indicates the administrative interpretation of the word "executed" in this statute. There was an agreement between two principal stockholders and the corporation in which they held stock that no dividends would be declared until certain advances of the two principal stockholders had been repaid by the corporation and the question presented was whether these were contracts within the meaning of the Act here in question. In other words, was this a written contract executed by the corporation? In passing upon this question the following significant language was used, namely, that the contracts were valid contracts "*entered into* in March 1936, that is prior to May 1, 1936." Here the emphasis properly is placed on the time element and the binding obligation, and not upon the *manner* of making the agreement.

VII.

Legislative History.

The legislative history affords only slight help by reason of the fact that the bill in the House and the bill in the Senate were divergent not only in wording but in aim and purpose.

> "The Conference Committee had the difficult task of reconciling in a limited time two diverse bills actuated by divergent views as to the

> proper attitude toward corporate wealth * * * The House and Senate 1936 bills were dissimilar in general aim, theory and in structure. The 1936 Act, as finally enacted, was to a considerable extent written in conference without any new statement of leigslative intent—a fact which contributes in no small measure to the difficulty of interpretation of the Act." *Paul & Mertens, Law of Federal Income Taxation 1939 Supp.*, Sec. 32 A. 05.

The result is a "hodge-podge." Martin, *"Taxation of Undistributed Corporate Profits,"* 35 Mich. Law Review 44, 72 (1936).

Thus, while specific statements of legislative intent are lacking on the bill as finally drafted and while comments made in the House and Senate are of little assistance due to the fact that this bill was a compromise drafted in conference, there is much to be gleaned as to legislative purpose from the background of the undistributed profits tax. The purpose of this surtax, as expressed in the Ways and Means Committee Report of the House, was fundamentally "a desire to stimulate distribution of corporate profits."

Paul & Mertens, *"Law of Federal Income Taxation,"* 1939 Supp. 32 A. .01, p. 1387, citing Ways and Means Committee Report No. 2475, 74th Congress, 2nd session, p. 5; Ways and Means Committee Hearings, p. 561; remarks of Senator Connally, Finance Committee Hearings, p. 203; Stempf "New Factors in Federal Income Taxation," 62 The Journal of Accountants 42, 247 (1936).

In other words, the uppermost thought was to cause surpluses that were *accumulating* to be handed

out to shareholders who would be taxable for the income so received.

The Congress had been advised as follows in the President's message of March 3, 1936:

> "The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtax. * * * "

This obviously is aimed at those corporations where *surpluses* have been voluntarily created because stockholders "who can afford to leave earnings undistributed" prefer that the corporation retain the *surplus* (House Report No. 2475, 74th Congress, Second Session). Also see *Sanford v. Commissioner,* 106 F. (2d) 882, 884; *Maryland Land and T. Co. v. Commissioner,* 40 B. T. A. 1066, 1067, and Senate Hearings p. 265 to 268—Examination of witness by Senator Black. The corporation faced with a deficit presented no problem because it could make no distribution of dividend and it is submitted that the Congress never intended to carry the idea of forced distribution to the point where a deficit corporation and its directors must commit an illegal act to make the distribution.

Not only must the Commissioner assert that the Congress intended to compel such illegal distribution by deficit corporations but he also must contend that the Congress actually intended to discriminate *against* such deficit corporations restrained by law from making dividends, by cutting off their access to the dividend paid credit. The result is harsh and the reasoning by which the result is obtained is technical and unsound.

Appellant devotes much space to legislative his-

tory. But summarized, the argument on this score is that Congress in 1936 intended to tax deficit corporations who could *not* distribute dividends and to exempt those who could and did distribute dividends, and that, in 1938, Congress realized the injustice of the measure and

> "For this reason, among others, substantially modified"

the Act. Appellant's argument requires that an injustice, recognized as such, be corrected by legislation. Appellee's argument follows that construction of the Act consistent with its purpose and wording which defeats the injustice at its source. Appellant's argument assumes that the lawyers on the committee were unaware of the time honored principle that a corporate charter is a contract. Appellant's argument further assumes that the elimination of a provision in a totally different bill, which provision taxed earnings 22 per cent if above the deficit, imports an intent in the Senate bill to tax irrespective of a deficit. Appellant confuses the beliefs of the majority and the minority of the committee. The *minority* report (80 Cong. Rec., Pt. X. p. 10164) points out that the *majority* ("the defenders of the bill") contend that by exemptions and modifications the smallest corporations are assisted. This is hardly consistent with an intent to tax deficit corporatons.

We take sharp issue with that portion of Appellant's brief which argues that the "Failure of Congress to provide specifically for the relief of deficit corporations was deliberate."

We submit that the remedy afforded in 1938 of a situation brought about by an unwarranted ad-

ministrative interpretation evidences an intent by Congress to give relief to deficit corporations.

VIII.

Stock Certificate.

The argument advanced in the Crane-Johnson brief on behalf of the taxpayer that the stock certificate is a contract within 26 (c) (1) is adopted by Appellee herein. A brief statement of the argument will suffice in view of such reference to the Crane-Johnson brief. Appellant does not question the premises that the stock certificate is a contract (*Clearwater v. Meredith*, 1 Wall. 25, 40) and that the state corporation law is a part of that contract (*Home Bldg. & Loan Assn. v. Blaisdell*, 290 U. S. 398, 429, 430). Appellant argues that the corporation laws are not "expressly written' in the stock certificate and are therefore a part of the certificate by implication only. The statute, however, refers to a provision expressly dealing with dividend payments rather than a provision expressly written in the contract.

It is a matter of common knowledge that corporations issue stock certificates. At the time of the conversations with the bank, the question of whether stockholders should receive dividends was broached. Obviously these stockholders held stock certificates.

Appellee urges, however, that the *manner* of execution is unimportant. The time when the contract came into effect is important. In that light, whether we refer to a stock certificate or to a charter, a contract had been entered into and was binding upon the corporation.

IF CONSTRUED TO DISALLOW THE CREDIT THE ACT IS UNCONSTITUTIONAL.

I.

The Act Is Arbitrary and Discriminatory in Violation of the Fifth Amendment to the Federal Constitution.

If the construction contended for by the Commissioner is adopted, then corporations who reduced to writing contracts entered into by them would receive a credit, whereas those making verbal agreements, as was the case with Northwest Steel in its agreement with the bank (R. 41, 47, 50) would receive no credit. Further, corporations which make contracts with individuals receive the credit, but because the corporation has made its contract with the state (a contract of the highest order) then under the Treasury's construction the corporation is prevented from obtaining the credit. If such construction is adopted of the statute, then the statute is arbitrary and discriminatory, for there is no reason to make one rule with respect to a private contract and another rule with respect to a contract between the corporation and the State, both contracts being in writing.

As between an oral and a written contract, it will be argued that there is reasonableness in drawing a distinction because of the difference in proof, but this contention is of no avail with respect to a corporate charter. No reasonable distinction can be drawn between a charter and any other type of written contract.

A Federal statute passed under the taxing power may be so arbitrary and capricious as to cause it

to fall before the due process of law clause of the Fifth Amendment. *Heiner v. Donnan,* 285 U. S. 312, 330-332; 76 L. Ed. 772, 781, 782. *Tyler v. U. S.* 281 U. S. 497, 504; 74 L. Ed. 991, 999.

The language in *Nichols v. Coolidge,* 274 U. S. 531, 542, 71 L. Ed. 1184, 1192, is by analogy pertinent to this situation.

> "The statute requires the executors to pay an excise ostensibly laid upon transfer of property by death from Mrs. Coolidge to them but reckoned upon its value plus the value of other property conveyed before the enactment in entire good faith and without contemplation of death. Is the statute thus construed within the power of Congress?
>
> "Undoubtedly, Congress may require that property subsequently transferred in contemplation of death be treated as part of the estate for purposes of taxation. This is necessary to prevent evasion and give practical effect to the exercise of admitted power *but the right is limited by the necessity.*"
>
> "Under the theory advanced for the United States the arbitrary, whimsical and burdensome character of the challenged tax is plain enough. An excise is prescribed but the amount of it is made to depend upon *past lawful transactions,* not testamentary in character and beyond recall. * * * *Different estates must bear disproportionate burdens determined by what the deceased did one or twenty years before he died.* See *Frew v. Bowers* (CCA 2d), 12 Fed. 2d 625.
>
> "This Court has recognized that a staute

purporting to tax may be so arbitrary and capricious as to amount to confiscation and offend the 5th Amendment. *Brushaber v. Union Pacific R. Co.*, 240 U. S. 1, 24; 60 L. Ed. 493, * * *

"And we must conclude that Section 402 (c) of the statute here under consideration, insofar as it requires that there shall be included in the gross estate the value of property transferred by a decedent *prior to its passage* merely because the conveyance was intended to take effect in possession or enjoyment at or after his death, is arbitrary, capricious and amounts to confiscation." (Italics supplied.)

So, here, the tax and the credit are based upon some act done in the past. There must be some reasonable ground for distinguishing between such acts. There is no *necessity* to impose the tax on deficit corporations to prevent evasion. There is no *necessity* to discriminate between a written contract and a charter. Such distinction would be purely arbitrary and capricious.

In addition to such arbitrary and unwarranted discrimination the tax as imposed upon deficit corporations prohibited by law from distributing a dividend amounts to confiscation of the property of the corporation without due process because the tax is imposed, not on income, but on undistributed income and there is no undistributed income so long as there is a deficit. *Willcuts, Collector v. Milton Dairy Co.*, 275 U. S. 215, 218; *Roy J. Kinnear v. Commissioner*, 36 BTA 153, 155; *Foley Securities Corp. v. Comm'r.*, 106 F. (2d) 731. Thus, in reality, the tax is on capital, not income. Likewise, the distribution to the stockholder would be capital and

not income. *Eisner v. Macomber,* 252 U. S. 189.

Appellee could not receive a credit for a dividend paid upon making such a "distribution." Under the Act, undistributed net income is adjusted net less the sum of the *dividends paid* credit. Section 27 (h) provides that if any part of a distribution is "not a taxable dividend" in the hands of the shareholders, no dividends paid credit shall be allowed with respect to such part. Congress cannot make that a dividend which is distribution of capital. If it could, the distribution would not have availed Appellee because Appellee, "as of the close of the taxable year" had no "earnings or profits" within the meaning of Sec. 115 (a) (2). *Roy J. Kinnear v. Comm'r.,* 36 BTA 153, 155, 156. Change in the statute there construed does not alter the principle there applied. Also see *Foley Securities Corp. v. Comm'r.,* 106 F. (2d) 731.

If the Act is construed as allowing a dividend paid credit to a deficit corporation, then it discriminates between deficit corporations. The corporation whose contract with the State prevents a distribution is denied the credit; the corporation whose contract with the State does not prohibit distribution of its assets even though a deficit exists can obtain the credit by a "dividend paid credit." All of these distinctions rest upon some act done prior to the enactment of this law and not in contemplation of the law No claim can be made that the act of entering into a charter is an illegitimate act or an act possessing any intent on the part of a corporation to avoid any tax or other exaction. If it be said that Congress may in its discretion allow or disallow credits, then our answer is that Con-

gress may not, under the pretext of taxing income, tax capital disproportionately. If it be said that Congress may discriminate reasonably, then our answer is that a discrimination between a written contract and a charter is unreasonable, arbitrary and in disregard of all legal principles. We submit that Congress had no such intention to discriminate and that the discrimination has arisen solely as the result of the Treasury's unwarranted regulations. But if the statute must be read to invoke such discrimination, then we respectfully urge that the Act should be stricken down as applied to Appellee as arbitrary, capricious, unreasonable and therefore unconstitutional. In addition, if there are doubts as to the constitutionality, then the statute should be so construed as to avoid such doubts. We submit that the following statement from the majority opinion of the Circuit Court is correct:

> "This impels the conclusion that the Act in question should be construed so as to include the taxpayer's corporate charter within the term 'written contract executed by the corporation,'."
>
> 'There seems to be grave doubt as to whether there is a reasonable basis for discrimination between a written contract actually 'signed' by a corporation prohibiting the payment of dividends, and the contract of the charter to which the corporation is as fully bound, likewise prohibiting the distribution of profits. The 'administrative convenience,' which we have above held lends a basis for the distinction between oral and written contracts, would not seem to

apply with equal force to this situation." (R. 81, 82.)

Appellant argues that classification of income as distributed or undistributed is proper, citing *Helvering v. National Grocery Co.*, 304 U. S. 282. The Act construed in that case pertained to corporations which were *formed or availed of* for the purpose of accumulating income and thereby preventing the imposition of surtaxes on their stockholders. The gist of the tax there was not alone the failure to distribute dividends but the deliberate use of the corporation for the purpose of avoiding tax on the individual stockholder. Kohl was the sole owner of the business. The question was whether a corporation "availed of" by him for the purpose of avoiding surtax upon his individual income could be taxed 50 per cent of its net income in addition to normal tax. A condition precedent to the additional tax on net income was the "existence of a defined purpose" "of preventing the imposition of the surtax" upon Kohl. The act was in effect designed to prevent fraud as is shown by the citation of *Helvering v. Mitchell*, 303 U. S. 391, in support of the opinion.

There is a substantial difference between the imposition of a tax based upon non-distribution plus a purpose to avoid surtax and a tax on undistributed net income where not only the purpose to avoid tax is lacking, but the distribution can not legally be made.

Appellant states that Congress may make any classification reasonably designed "to afford an equitable distribution of the tax burden." How the instant measure as applied to Appellee can be jus-

tified as an *equitable* distribution of the tax burden under Appellant's construction is beyond understanding.

Almours Securities v. Commr., 91 Fed. (2d) 427 (CCA-5), is cited. The holding there was that taxpayer had accumulated profits beyond reasonable needs of its business and the corporation was "availed of" for the *purpose* of preventing imposition of surtaxes upon its shareholders. The decision recognizes that the means employed to carry out a legitimate taxing purpose must be "plainly adapted to that end" (p. 429). Is the means "adapted to that end" when a corporation is taxed because of accumulated, undistributed profits when in fact there are no accumulated profits and no distribution could be made legally?

In *United Business Corporation v. Commr.*, 62 Fed. (2d) 754, the *intent* of taxpayer is stressed.

> " * * * The test remains the state of mind itself." (p. 755.)
>
> "While the forbidden purpose is of those who use the company, that purpose may be imputed to the company itself, since they can not use it unless they are in control, and it can have no other than an imputed purpose anyway." (p. 756.)

Intent to use a corporation to evade personal tax may give rise to regulation as an incidence to tax. That is a far cry, however, from regulation designed to tax a corporation to force it to do that which it can not legally do because of its contract with the state and stockholders.

In any event, the tax is not upon corporate profits as such, but the tax is intended to require distribu-

tion of those corporate profits to individuals. The distinction between distribution and non-distribution is not because one corporation is paying a lighter tax than another. In effect the law is a tax upon a corporation engaged in entirely legitimate pursuits to require the corporation to hand over funds to stockholders so that the stockholders can be taxed in a greater amount.

Appellant argues that this tax is valid because credits are matters of legislative grace. That is no answer to the objection that as to deficit corporations, the tax is upon capital and not on income.

Further, an act which is arbitrary and discriminatory is not made less so because Congress could have granted a credit which would have operated to prevent discrimination in a particular case.

Appellant urges that an "intolerable burden" would be imposed in administering the law. The Bureau is "conclusively presumed" in its dealings with the corporation to have "knowledge of its charter." *Loveland & Co. v. Doernbecher Mfg. Co.* (Ore.) 39 Pac. (2d) 668, 673. Would it be "intolerable" if a written contract between X corporation and a creditor provided that so long as X corporation was insolvent it must not declare dividends? If not, then the problem of administration is no greater with respect to charters. In the one case there must be a determination of fact as to insolvency, and in the other a determination of fact as to a deficit. Internal Revenue officials must often consider state laws. See *Lang v. Commr.*, 304 U. S. 264; *Blair v. Commr.*, 300 U. S. 5; *Crooks v. Harrelson*, 282 U. S. 55.

And so long as "practical considerations" are being discussed, we submit the administrative problem is comparatively simple to the problem presented to the taxpayer who must violate the state law to obtain the Federal tax credit, under the Bureau's interpretation.

> "However, to construe statutes so as to avoid results glaringly absurd, has long been a judicial function." *Armstrong Paint & V. Works v. Nu-Enamel Corp.*, 305 U. S. 315, 333.

This statute presents a situation where the above quote is unusually apt. It is "glaringly absurd" for the Federal Government to require payment of a tax because the State Government makes unlawful the distribution of a dividend.

In connection with the argument of intolerable burden, it is well to bear in mind that for purposes of annual depreciation deduction, corporate assets of all corporations have been valued. Furthermore, the Bureau considers valuation for purposes of capital stock tax and of estate tax valuations. There are annual income tax returns. The Agents have access to the books of the corporation. Each year, the corporation is under scrutiny. If any sale of physical assets is made, that sale is subject to study by reason of possible gain or loss. The ascertainment of such facts has never been considered insuperable. Having such facts, the ascertainment of a *surplus* or deficit should not be intolerable.

II.

The Act Constitutes an Invasion by the Federal Government of the Powers Delelgated to the States to Regulate Corporations and Violates the Tenth Amendment.

"Powers not yet delegated to the United States by the Constitution, nor prohibited by it to the State, are reserved to the States respectively, or to the people." Amendment X, *Federal Constitution.*

States have the inherent power to prescribe the powers of corporations and the conditions under which those powers may be exercised. 14 *C. J.*, "Corporations," §56, p. 94:

" * * * While the States are not sovereign in the true sense of that term, but only quasi sovereign, yet in respect of all powers reserved to them they are supreme—'as independent of the Federal Government as that Government within its sphere is independent of the State.' * * * It is no longer open to question that the general government, unlike the State * * * possesses no inherent power in respect of the internal affairs of the State; and emphatically not with regard to legislation." *Carter v. Carter Coal Co.,* 298 U. S. 238, 294, 295; 80 Law Ed. 1160, 1180.

To the same effect:

Thurlow v. Mass., 5 How. 504, 588, 12 Law Ed. 256, 294.

"A state, through its Legislature, may regulate all corporations, without regard to their nature, just the same as they may regulate an individual, except insofar as the power to regulate is precluded by constitutional provisions or by provisions in the charter or franchise."

Fletcher Cyc. Corporations (Perm Ed.) Vol. 14, Chap. 59, Sec. 6684, page 39.

"The power of taxation, which is expressly granted, may, of course, be adopted as a means to carry into operation another power also expressly granted. But resort to the taxing power to effectuate an end which is not legitimate, not within the scope of the constitution, is obviously inadmissible.

" 'Congress is not empowered to tax for those purposes which are within the exclusive province of the states.' Gibbons v. Ogden, 9 Wheat. 1, 199, 6 L. Ed. 23, 70."

" 'There are, indeed, certain virtual limitations, arising from the principle of the Constitution itself. It would undoubtedly be an abuse of the (taxing) power if so exercised as to impair the separate existence and independent self government of the states, or if exercised for ends inconsistent with the limited grants of power in the Constiution.' *Veazie Bank v. Fenno,* 8 Wall. 533, 541, 19 Law Ed. 482, 485." *U. S. v. Butler,* 297 U. S. 1, 69, 80 Law Ed. 477, 490, 102 A.L.R. 914, 927.

In the Butler case, the Government argued that the plan was voluntary and therefore avoided constitutional objections, but this Court's opinion stated:

"The farmer, of course, may refuse to comply but the price of such refusal is the loss of benefits. The amount offered is intended to be sufficient to exert pressure on him to agree to the proposed regulation." (pp. 70, 71 (U.S.); 491 (Law Ed.))

So here, the taxpayer may obey the State law and make no distribution of dividend and pay the tax. But the Federal tax is:

> "Intended to be sufficient to exert pressure on him."

to make the distribution. This is evident from the statements of purpose behind the law.

> " 'A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score.' * * *
>
> "Obviously, direct control of medical practice in the state is beyond the power of the Federal Government. Incidental regulation of such practice by Congress through a taxing act can not extend to matters plainly inappropriate and unnecessary to reasonable enforcement of a revenue measure. * * *" *Linder v. U. S.*, 268 U.S. 5, 17, 18, 22, 69 Law Ed. 819, 823, 825.

It is not necessary for the reasonable enforcement of this revenue measure that a corporation should be compelled or by pressure of taxation, induced to make a distribution contrary to the laws of the State and possibly to the jeopardy of creditors of the corporation. If it was the intent of Congress that, irrespective of State regulations to the contrary, the tax would compel or induce the corporation to make the distribution or else pay an onerous penalty to the Federal Government for the failure to make that distribution (one expressed purpose of this undistributed profits tax was to accelerate the distribution of money held by corporations), then we submit that the Act was beyond the power of Congress and results in a direct interference with the control by the State of corporations.

III.

Tax Is Not On Income Within Sixteenth Amendment But Is On Capital and Is Invalid Because Not Apportioned.

It is not net income of the corporation which is taxed, but rather *undistributed* net income. *Undistributed* net income is arrived at after determining an *adjusted* net income, but with deficit corporations there can be no such thing as *undistributed net income* because all earnings must automatically help replace the deficit. Since Appellee had no undistributed surplus, this tax, if imposed, would be directly upon the capital of the company and must be apportioned.

In *Willcuts v. Milton Dairy Co.*, 275 U.S. 215, 218, 72 Law Ed. 247, 248, it is stated:

> "Hence, where the capital is impaired, *profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute 'undivided profits.'* * * * We do not think Congress intended that a corporation whose capital was impaired should be entitled to treat profits that, though earned, were insufficient to make good the impairment and create a surplus, as 'undivided profits.' This would not only give the term 'undivided profits' a meaning entirely at variance with ordinary usage,—making it merely equivalent to any earned profits remaining in the business,—but would grant the privilege of twice disregarding the impairment of capital, that is, once in computing the paid-in capital, which under the express terms of the act was to be taken at the full cash or

money value at the time of payment, and again in computing the 'undivided profits.' This term is entirely inept to express such a purpose." (Italics supplied.)

So here there could be no *undistributed* income so long as the income made during the tax year was needed to relieve an impairment of capital. Any tax imposed on so-called undistributed income was therefore no more than a tax upon capital. As such it is not an income tax within the 16th Amendment and must be apportioned. *Eisner v. Macomber,* 252 U.S. 189, 64 Law Ed. 521. In that case this Court stated:

"That Congress has power to tax shareholders upon their property interest in the stock of corporations is beyond question; and that such interest might be valued in view of the condition of the company, including its accumulated and undivided profits, is equally clear. But that this would be taxation of property, because of ownership, and hence would require apportionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this Court." (p. 217.)

"Thus from every point of view we are brought irresistibly to the conclusion that neither under the 16th Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, *or the accumulated profits behind it,* as income of the stockholder. The Revenue Act of 1916, insofar as it imposes a tax upon the stockholder because of such dividend, contravenes the provisions of Article

I, Section 2, Clause 3, and Article I, Section 9, Clause 4 of the Constitution, and to this extent is invalid notwithstanding the 16th Amendment." (Italics supplied) (p. 219.)

The reasoning in the *Eisner v. Macomber* case is simply that a stock dividend represents no division of income derived from capital but merely represents a division of capital. Similarly if Appellee had made a division of its undistributed income, it would not have been dividing something which accrued from capital or was derived from capital, but it would have been dividing the very capital itself.

We are not dealing with a corporation formed for the purpose of evading taxes or used as a device to prevent taxation as in *Helvering v. National Grocery Co.*, 304 U. S. 282, 82 Law Ed. 1346. We are dealing with a corporation which obeys the law by refusing to distribute a dividend because its capital is impaired. We are dealing with a tax measure which imposes a so-called undistributed profits tax irrespective of whether the profits are needed to restore capital or may be used for dividend distribution. Taxes are real things and should be judged by practical standards. It is fiction to call a tax upon that portion of a corporation's profits needed to restore an impaired capital, an *income* tax.

CONCLUSIONS.

A binding contract was in existence between Appellee and the State prior to May 1, 1936. The terms and provisions of that contract included the incorporation laws. Without that inclusion no charter could have been obtained. One of the conditions imposed upon Appellee restricted dividend payments

while a deficit existed. This condition was imposed for reasons of public policy. The credit under Section 26 (c) (1) should be allowed.

If the credit is disallowed, the tax is in reality not on income but on capital and not apportioned. There is discrimination as between corporations prohibited by charter and those prohibited by another type of written contract from distributing dividends. There is coercion, interfering with state regulation of corporations. Thus if the credit is disallowed, the Act is unconstitutional as applied to Appellee.

The decision of the Circuit Court should be affirmed and Appellee should be exonerated from the claimed deficiency of surtax.

Respectfully submitted,

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APPENDIX.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(*a*) *Definitions.*—As used in this title—

* * * * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

* * * * * * *

(U. S. C. Supp. IV, Title 26, Sec. 13a.)

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * * *

(*c*) *Contracts Restricting Payment of Dividends.*

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

Session Law 1933, p. 787 Sec. 25, Laws of the State of Washington, Rem. Rev. Stat. 3803-24, Vol 5.

"1. Every corporation shall carry upon its books as a liability the amount of its capital stock as defined in section 3803-1, subdivision 10.

"2. Amounts of surplus arising from an unrealized appreciation or revaluation of fixed assets shall be shown on the books of the corporation as a separate item apart from surplus profits or paid-in surplus.

"3. In computing the aggregate of the assets of the corporation the Board of Directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off, at least annually in proportion to their use as may be determined by the Board of Directors.

"4. *No corporation shall pay dividends.*

"(a). In cash or property, *except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock,* after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized depreciation in value or revaluation of fixed assets;

"(b). In shares of the corporation, *except from the surplus of the aggregate of its assets over the aggregate of its liabilities,* including in the latter the amount of its capital stock.

"5. Cash dividends shall not be paid out of surplus due to or arising from

"(a) Any profit on treasury shares before resale; or

"(b) Any unrealized profits due to increase in valuation of inventory before sale; or

"(c) The unaccrued portion of unrealized profits on notes, bonds or obligations for the payment of money purchased or acquired at a discount, unless such notes, bonds, or obligations are readily marketable, in which case they may be taken at their actual market value; or

"(d) The unaccrued or unearned portion of any unrealized profit in any form whatever whether in form of notes, bonds, obligations for the payment of money, instalment sales, credits or otherwise * * * "

* * * * * * *

Session Laws, 1933, p. 787, Sect. 25, Rem. Rev. Stat. 3803-25.

"If any dividend be paid in violation of Section 3803-24, or if any other unlawful distribution, payment or return of assets be made to shareholders,

"1. The directors who knowingly, or without making reasonable inquiry, voted in favor thereof shall be jointly and severally liable to the corporation in an amount equal to the amount of the dividend so paid and the distribution, payment or return of assets so made;

"2. Every shareholder who receives any such dividend or any such distribution, payment or return of assets, shall in the following instances be individually liable *to the corporation,* in an amount equal to the amount so received by him:

"(a) When no director is liable to the corporation as provided in Subdivision 1 of this section, or

"(b) To the extent that the corporation is unable to obtain satisfaction after judgment is recovered against directors upon the liability imposed by subdivision 1 of this section * * * "

* * * * * * *

Rem. Rev. Stat. 3823, Session Laws of 1923, p. 543, *Sec. 2.*

"It shall not be lawful for the trustees to make any dividend except from the net profits arising from the business of the corporation, nor divide, withdraw, or in any way pay to the stockholders, or any of them, any part of the capital stock of the company unless in the manner prescribed in this chapter, or the articles of incorporation or by-laws; and in case of any violation of the provisions of this section, the trustees, under whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large on the minutes of the board of trustees at the time, or were not present when the same did happen, shall, in their individual or private capacities, be jointly or severally liable to the corporation and the creditors thereof in the event of the dissolution, to the full amount so divided, or reduced, or paid out * * * ."

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SUPREME COURT OF THE UNITED STATES.

No. 121.—October Term, 1940.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* Northwest Steel Rolling Mills, Inc.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[November 12, 1940.]

Mr. Justice Black delivered the opinion of the Court.

Respondent corporation, because of a previously existing deficit, was prohibited by state law[1] from distributing as dividends its profits earned in 1936. Notwithstanding this state prohibition, the Commissioner held respondent liable under the 1936 Revenue Act[2] for surtax on undistributed profits. The Board of Tax Appeals sustained the Commissioner;[3] the Circuit Court of Appeals reversed.[4] On a similar state of facts the Court of Appeals for the Eighth Circuit held undistributed profits taxable.[5] We granted certiorari in both cases to resolve this conflict.[6]

Section 14 of the 1936 Act imposed a general surtax on corporate profits earned but not distributed as dividends during the tax year. Section 26(c)(1) of the Act relieved from such surtax all undistributed profits which the corporation could not distribute as dividends "without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

The only "written contract executed by the corporation" upon which respondent relies for its claimed exemption is its corporate

1 "No corporation shall pay dividends . . . except from the surplus of the aggregate of its assets over the aggregate of its liabilities. . . ." Wash. Rev. Stat. Ann. (Remington, 1932) tit. 25, section 3803-24.

2 49 Stat. 1648, 1655.

3 The memorandum opinion of the Board is not officially reported; the Board relied on its earlier opinion in Crane-Johnson Co. *v.* Commissioner, 38 B. T. A. 1355.

4 110 F. (2d) 286.

5 Crane-Johnson Co. *v.* Commissioner, 105 F. (2d) 740.

6 309 U. S. 692; 311 U. S. —.

charter, granted by the state of Washington. Upon the premises that respondent's Washington charter was a written contract, and that the Washington laws prohibiting dividend payments were by operation of law a part of that contract, the court below concluded that the taxpayer had satisfied the requirements of section 26(c)(1).

We must therefore decide whether section 26(c)(1) authorized a credit or deduction to corporations prohibited by state law from distributing dividends. And respondent strongly urges that the Act, if construed to deny such credit, is unconstitutional.

First. It is material that we are dealing here with a generally imposed surtax upon the undistributed net income of corporations, and that respondent's claim is for a credit in the nature of a specially permitted deduction. It has been said many times that provisions granting special tax exemptions are to be strictly construed.[7]

Measured by this sound standard it is probably not necessary to go beyond the plain words of section 26(c)(1) in search of the legislative meaning. Certainly, at first blush, few would suppose that when Congress granted a special exemption to corporations whose dividend payments were prohibited by executed written contracts, it thereby intended to grant an exemption to corporations whose dividend payments were prohibited by state law. The natural impression conveyed by the words "written contract executed by the corporation" is that an explicit understanding has been reached, reduced to writing, signed and delivered. True, obligations not set out at length in a written contract may be incorporated by specific reference, or even by implication. But Congress indicated that any exempted prohibition against dividend payments must be expressly written in the executed contract. It did this by adding a precautionary clause that the granted credit can only result from a provision which "expressly deals with the payment of dividends."

That the language used in section 26(c)(1) does not authorize a credit for statutorily prohibited dividends is further supported by a consideration of section 26(c)(2). By this section, a credit is allowed to corporations contractually obligated to set earnings aside for the payment of debts.[8] That this section referred to

[7] E. g., Deputy *v.* du Pont, 308 U. S. 488, 493; White *v.* United States, 305 U. S. 281, 292; New Colonial Ice Co., Inc. *v.* Helvering, 292 U. S. 435, 440.

routine contracts dealing with ordinary debts and not to statutory obligations is obvious—yet the words used to indicate that the section had reference only to a "written contract executed by the corporation" are identical with those used in section 26 (c)(1). There is no reason to believe that Congress intended that a broader meaning be attached to these words as used in section 26(c)(1) than attached to them under the necessary limitations of 26(c)(2).

Respondent urges that the legislative history of section 26(c)(1) supports its contention. But, on the contrary, that history points in the other direction. The original House Bill contained separate relief provisions (1) for deficit corporations such as respondent; (2) for corporations contractually obligated to pay debts; and (3) for corporations contractually prohibited from paying dividends.[9] The Senate Finance Committee struck out all three of these House provisions, but substituted an equivalent for the third.[10] An amendment from the Senate floor restored an equivalent of the second.[11] But the bill as finally passed contained no express relief provision relating to deficit corporations.

It is true, as respondent contends, that a charter has been judicially considered to be a contract insofar as it grants rights, properties, privileges and franchises.[12] To this extent it has been said that an Act of Incorporation is a contract between the state and the stockholders.[13] But it does not follow that Congress intended to include corporate charters and related state laws in the cautiously limited area permissible for tax credits and deductions under this section. Nor have the courts considered that all the provisions of laws providing for the grant of corporate franchises are necessarily contractual in their nature. The same legislative Act is a law as

[8] 49 Stat. 1664. The credit allowed is "An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside."

[9] H. R. 12395, 74th Cong., 2d Sess., sections 14, 15, and 16; see H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 8-9.

[10] See S. Rep. No. 2156, 74th Cong., 2d Sess., pp. 12-13, 15-16.

[11] 80 Cong. Rec. 9071, 74th Cong., 2d Sess.

[12] Trustees of Dartmouth College *v.* Woodward, 4 Wheat. 518; Home Building & Loan Ass'n *v.* Blaisdell, 290 U. S. 398, 429.

[13] Chenango Bridge Co. *v.* Binghamton Bridge Co., 3 Wall. 51, 73.

well as a grant, and this Court has held that the same legislative enactment may be both a contract—which cannot be impaired—and a law, subject to repeal, modification, alteration, or amendment within the general legislative powers.[14] Respondent's chief reliance is upon that charter provision which required that it conform to the existing and future laws of Washington. But that provision is not a grant and is not a contract. With or without such a charter provision, it was the duty of the corporation to conform to valid Washington statutes. The corporation was subject to the law of Washington; it could not rise above it. A corporate charter to operate a particular business in a particular manner does not deprive the state of its inherent power of legislation touching corporate activities. And the grant of a franchise does not exempt the corporation from the requirement that it obey state legislation validly adopted in the interests of the public welfare.[15] It cannot be said, therefore, that the charter provision that the corporation should obey Washington law, including the statutory prohibition against distributing dividends, was a provision of a written contract executed by respondent. More, the Constitution of the State of Washington under which the general corporation laws were enacted provides that "All laws relating to corporations may be altered, amended, or repealed by the legislature at any time, and all corporations doing business in this state may, as to such business, be regulated, limited, or restrained by law."[16] It is clear, therefore, that what prohibited respondent from distributing dividends was not the provision of an executed written contract expressly dealing with the payment of dividends. On the contrary, what prohibited respondent from paying dividends was a valid law of the State of Washington.[17]

Second. Respondent contends that the tax statute, as construed, offends the Fifth, Tenth and Sixteenth Amendments. None of those contentions is valid.[18]

It is argued that the Act offends the Due Process clause of the Fifth Amendment because it permits credits or deductions in the

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[14] Oregon & California Railroad Co. *v.* United States, 238 U. S. 393, 427.

[15] Hammond Packing Co. *v.* Arkansas, 212 U. S. 322, 345.

[16] Washington Constitution, Article 12, § 1.

[17] Respondent contended that the stock certificates satisfied the statutory requisites even if the charter did not; but what we have here said with respect to the charter applies equally to the certificates.

[18] Cf. Helvering *v.* National Grocery Co., 304 U. S. 282.

case of corporations restrained from a distribution of dividends under a given type of written contract, while not permitting any credit or deduction to corporations restrained from distribution by oral contracts or by the laws of a state. This contention is without merit. It is not necessary to point out the many obvious reasons that might underlie the distinctions here drawn in granting special deductions from a generally imposed tax.

Respondent also urges that the tax as applied to it amounts to a confiscation of its property without Due Process of law because the tax is imposed, not on income, but only on undistributed income, and that there can be no undistributed income so long as the corporation has an existing deficit. But the surtax here is imposed upon the undistributed net income of the corporation "for each taxable year." It is true that the surtax is imposed upon the annual income only if it is not distributed, but this does not serve to make it anything other than a true tax on income within the meaning of the Sixteenth Amendment. Nor is it true, as respondent urges, that because there might be an impairment of the capital stock, the tax on the current annual profit would be the equivalent of a tax upon capital. Whether there was an impairment of the capital stock or not, the tax here under consideration was imposed on profits earned during a definite period—a tax year—and therefore on profits constituting income within the meaning of the Sixteenth Amendment.

It is contended that the statute as here applied violates the Tenth Amendment because it interferes with the authority of the states to prescribe the powers of corporations and the conditions under which their powers may be exercised. But the statute in no way limits the powers of the corporation. It imposes a tax as authorized by the Sixteenth Amendment and does not infringe upon the powers reserved to the state by the Tenth Amendment.[19] The court below was in error; its judgment is reversed and the cause is remanded with directions to affirm the judgment of the Board of Tax Appeals.

Reversed.

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[19] Helvering *v.* National Grocery Co., *supra*, at 286-287. And cf. Florida *v.* Mellon, 273 U. S. 12, 17: "Congress cannot accommodate its legislation to the conflicting or dissimilar laws of the several states nor control the diverse conditions to be found in the various states which necessarily work unlike results from the enforcement of the same tax."